

# The Insolvent Life Care Provider: Who Leads the Dance Between the Federal Bankruptcy Code and State Continuing-Care Statutes?

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*Continuing-care retirement communities provide seniors with an attractive option to traditional nursing homes. These arrangements allow seniors to live in a pleasant, independent environment for as long as possible, and then receive life time nursing care when it is needed. Residents of these communities pay a large upfront entry fee in exchange for the promise of life time nursing care.*

*When continuing care facilities file for bankruptcy, however, residents risk losing their large upfront entry fee, which drastically reduces the value of these arrangements to consumers. In this Article, Professor Nathalie Martin analyses these risks against a host of state statutes purporting to regulate this industry. She concludes that despite many laws on the books, this industry remains largely unregulated, and resident fees are still at great risk of loss in most states.*

*In the Article, Professor Martin analyses the relationship between state statutes and the Federal Bankruptcy Code, and discusses the Supremacy battle that results when state and federal statutes conflict. She analyses the specific provisions of the various state continuing-care statutes and suggests ways that the state statutes could be improved. She then concludes that because the Bankruptcy Code preempts some of the provisions of these state statutes, and because the state legislative process is inefficient and unpredictable, to fully protect residents from the loss of their life care investments, the Bankruptcy Code should also be amended to preclude rejection of life care contracts, to provide rejection damage claims with higher priority, or to otherwise protect resident claims.*

## I. INTRODUCTION

Let's face it. None of us is getting any younger. People are living longer,<sup>1</sup> younger people are leading more complicated lives,<sup>2</sup> and everyone is seeking

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<sup>1</sup> See Marshall B. Kapp, *Options for Long-Term Care Financing: A Look to the Future*, 42 HASTINGS L.J. 719, 721 (1991).

<sup>2</sup> See *infra* notes 44–47 and accompanying text.

high-quality, dignified care for the elderly.<sup>3</sup> Due to changes in the family structure, many older people today eventually find themselves in nursing homes and other long-term eldercare facilities.<sup>4</sup> In the last twenty years, a new nursing care alternative has become available, through which elderly people pay a substantial up front fee in exchange for a promise of guaranteed nursing care for the rest of their lives.<sup>5</sup> The facilities providing this care are known as life care or retirement communities.<sup>6</sup> Contracts with such a facility often allow residents to live independently in their own apartments at the facility for as long as possible, and later move into various levels of assisted living, all for a prepaid fee.<sup>7</sup> This new option provides older people with a way to live independently for many years, while at the same time insuring against the risk that their nursing care costs will eventually exceed their available funds.<sup>8</sup>

Despite their many benefits, continuing-care facilities ("CCFs") are particularly susceptible to insolvency.<sup>9</sup> Once insolvency occurs, the prospects for residents can be grim. In Idaho, after one facility failed, some residents lost their life savings.<sup>10</sup> According to testimony given to the Idaho legislature, "two [of the] women who had used life savings for [the new living arrangement] learned that . . . they were, in a word, paupers. These were people who had worked and

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<sup>3</sup> See *Onderdonk v. Presbyterian Homes of N.J.*, 425 A.2d 1057, 1064 n.5 (N.J. 1981) (stating that adequate housing and health care for the elderly has become one of society's most pressing needs); see also Administration on Aging, U.S. Dep't of Health & Human Servs., *President Clinton and Vice President Gore: Strengthening Families That Need Long-Term Care* (last modified Jan. 4, 1999) <<http://www.aoa.dhhs.gov/aoa/ltr1-4-99.html>> (on file with the author).

html>. The aging population is increasing because Americans age 65 years or older will double by the year 2030, from 34.3 million to 69.4 million. The White House has revealed a proposal to support a long-term care initiative, which addresses elderly health care needs. See *id.*

<sup>4</sup> See Marsha King, *Agents for the Aged: Care Managers Serve as Troubleshooters*, THE SEATTLE TIMES, May 20, 1999, at A1. It has become more common that adult children of elderly parents are scattered across the country and are not able to care for their aging parents. The need for nursing homes and other facilities catering to geriatric care has become prevalent in today's society.

<sup>5</sup> See *infra* notes 40–102 and accompanying text.

<sup>6</sup> See *infra* notes 48–52 and accompanying text.

<sup>7</sup> See *infra* notes 48–58 and accompanying text.

<sup>8</sup> See *id.*

<sup>9</sup> See *infra* notes 59–85 and accompanying text. The financial health of a life care provider will depend upon as many factors as any other business, as well as on the provider's accuracy in predicting the nursing care costs and life span of residents, investment success, and ability to jump through the necessary hoops to obtain various federal funds.

<sup>10</sup> See *Hearing on H. 626 Before the House Health & Welfare Comm.* (Idaho 1988) (statement of Lorraine Gunderson).

saved during their younger years in order to be independent.”<sup>11</sup> In addition to the loss of life savings, “the loss in self-esteem to the residents and dread of the future cannot be calculated in dollars.”<sup>12</sup> Recent changes in Medicare reimbursement policies will almost certainly result in more CCF insolvencies than ever.<sup>13</sup>

When a provider fails financially, it has a number of legal options, none of which are very satisfactory for residents.<sup>14</sup> First, it can cease its operations and hope the state has provided for the transfer of the residents.<sup>15</sup> Another option is to file a state insolvency proceeding, which will normally require liquidation, but which may permit a rehabilitation of some sort.<sup>16</sup> Finally, it could file a federal bankruptcy proceeding, which has one immediate advantage over state proceedings, namely a regular method of reorganizing under the provisions of Chapter 11 of the Bankruptcy Code.<sup>17</sup> Under Chapter 11, the provider can continue to operate without the immediate appointment of a trustee, and will also receive the benefits of a plethora of specialized bankruptcy provisions that aid rehabilitation.<sup>18</sup>

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<sup>11</sup> See *id.*

<sup>12</sup> See *id.*; see also Kapp, *supra* note 1, at 719 (noting that “[t]he greatest single threat to the financial security of the elderly is the cost of long-term care”). Even courts have acknowledged that the emotional upheaval caused by a CCF insolvency far exceeds the damage done in dollars. See *In re The Brethren’s Home*, 24 B.R. 336, 343 (Bankr. S.D. Ohio 1982).

<sup>13</sup> Until recently, Medicare paid unlimited rehabilitation and therapy for senior citizens in nursing homes and CCFs, but the federal government is now severely limiting these reimbursements. As a result, huge numbers of nursing homes are failing financially, and CCFs can be expected to follow suit. See, e.g., Chris Adams, *GAO: Medicare Changes Making Nursing Homes More Selective*, WALL ST. J., Dec. 23, 1999, Harold J. Adams, *Another Nursing Home Goes Bankrupt: Mariner Joins Sun Healthcare and Vencore*, THE COURIER J., Jan. 19, 2000, at 14B; Garmen Shiu, *Nursing Home Residents Left Homeless: Bankruptcy Shuts Down Reseda Care Center Without Warning*, (visited Jan. 20, 2000) <<http://www.cbs2.com/news/stories/news-970927-103926.html>> (on file with the author); Bob LaMendola, *Bankrupt Chain Keeps S. Florida Sites Open*, SUN SENTINAL, Feb. 4, 2000, at 1D; Scott Thurston, *Nursing Home Operator Seeks to Reorganize its Finances*, ATLANTA J. & CONST., Jan. 18, 2000, at D3.

<sup>14</sup> See *infra* notes 264–90 and accompanying text.

<sup>15</sup> Florida, for example, covers some of the costs of moving residents to another facility, from a general state fund. See FLA. STAT. ch. 651.119 (West 1996). Most states, however, have not so provided.

<sup>16</sup> Many state continuing-care statutes permit a facility to file a state liquidation or rehabilitation proceeding and also permit the state official in charge to institute such a proceeding against a facility. See *infra* notes 236–55 and accompanying text.

<sup>17</sup> See 11 U.S.C. §§ 101–1330 (1994).

<sup>18</sup> See *infra* notes 236–55 and accompanying text.

If the Bankruptcy Code makes rehabilitation easier for a debtor, it obviously does so at the expense of other interested parties in a case. One of the primary benefits a debtor obtains in bankruptcy is the ability to reject prepetition contracts, including those executed by CCF residents, for which some residents may have paid their life savings.<sup>19</sup> Prepaying for anything is risky, but the risks are particularly great for parties to continuing-care contracts. Residents whose contracts are rejected receive only bankruptcy claims for their losses, which are typically paid at extremely low rates, and for which replacement services cannot be obtained.<sup>20</sup>

These increased risks for continuing-care residents have caught the attention of state legislatures, who have enacted a variety of state statutes to address these risks.<sup>21</sup> While the precise goal of enacting this legislation is to protect residents from the loss of their savings, many statutes do not achieve this goal because they are preempted by the Bankruptcy Code.<sup>22</sup> Thus, states have tried to help CCF residents, but have instead caused more harm than good, and have given residents a false sense of security.<sup>23</sup>

Using the continuing-care cases as an example of what works best and most efficiently when state and federal laws clash, Part II of this Article discusses the history and importance of continuing-care contracts in light of the aging population.<sup>24</sup> Part III discusses the Supremacy Clause of the Constitution as applied to the Bankruptcy Code, and analyzes some of the many provisions states have enacted to protect residents from CCF insolvencies.<sup>25</sup> While some attempts by states are clearly unenforceable and ineffective under the Supremacy Clause, others have been extremely creative. Maine, for example, has legislated that CCFs constitute insurance companies under state law and are thus ineligible for bankruptcy protection under section 109 of the Bankruptcy Code.<sup>26</sup> While it is unclear whether this attempt to preclude this industry from bankruptcy protection is effective, the possibility raises interesting questions. Should states be allowed to determine which industries are eligible for bankruptcy? Do the states talk to one another about their legislation, and do they know the effects of federal legislation on these enactments? After considering these issues, Part III concludes that, because state statutes vary, and are currently preempted on the

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<sup>19</sup> See *infra* notes 289–330 and accompanying text.

<sup>20</sup> See *infra* note 287 and accompanying text.

<sup>21</sup> See *infra* notes 170–283 and accompanying text.

<sup>22</sup> See *infra* notes 200–256 and accompanying text.

<sup>23</sup> See *id.*

<sup>24</sup> See *infra* notes 40–102 and accompanying text.

<sup>25</sup> See *infra* notes 103–283 and accompanying text.

<sup>26</sup> See ME. REV. STAT. ANN. tit. 24-A, § 6225 (West 1990 & Supp. 1999).

issues of insolvency and bankruptcy, amending the Bankruptcy Code is a more efficient way to protect all CCF residents in the event of insolvency than enacting state statutes.<sup>27</sup>

Part IV discusses the possible forms that these Bankruptcy Code amendments could take. First, this Part reviews various provisions of the existing Bankruptcy Code and discusses the unique problems these provisions create for CCF residents.<sup>28</sup> Specifically, this Part reviews section 365 of the Bankruptcy Code, which allows the debtor to reject the contracts of residents, as well as virtually all other contracts, under the lenient business judgment test. It discusses a debtor's unique capacity to overreach as a result of this provision.<sup>29</sup> This Part then considers, by way of example, several types of contracts that Congress chose to protect from rejection, to determine if a similar provision could be helpful to life care residents.<sup>30</sup> Part IV also considers whether residents could benefit if their rejection damage claims were given priority or secured status,<sup>31</sup> and briefly discusses the possibility of making CCFs ineligible for bankruptcy under section 109 of the Bankruptcy Code.<sup>32</sup> Part IV ultimately concludes that various provisions could be added to the Bankruptcy Code to protect the residents of continuing-care facilities.<sup>33</sup> Part IV argues that one or more of these amendments would provide much needed protections to residents of CCFs,<sup>34</sup> and would eliminate the need for state legislatures to enact inconsistent and often ineffective state laws.<sup>35</sup>

Part V discusses what we can learn about the legislative process from the intersection between state continuing-care statutes and the Bankruptcy Code.<sup>36</sup> Part V concludes that while state legislatures appear somewhat uninformed about existing federal legislation when they propose conflicting or preempted state legislation, the federal legislative process is not necessarily more rational.<sup>37</sup> The Bankruptcy Code amendment process suffers from its own deficiencies,

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<sup>27</sup> See *infra* notes 277–83 and accompanying text.

<sup>28</sup> See *infra* notes 284–305 and accompanying text.

<sup>29</sup> See *infra* notes 291–305 and accompanying text.

<sup>30</sup> See *infra* notes 306–89 and accompanying text.

<sup>31</sup> See *infra* notes 390–400 and accompanying text.

<sup>32</sup> See *infra* notes 401–05 and accompanying text.

<sup>33</sup> See *infra* notes 380–400 and accompanying text.

<sup>34</sup> See *id.*

<sup>35</sup> See *infra* notes 103–283 and accompanying text. While I ultimately conclude that enacting valid statutory liens on a state by state level is one of the best ways to protect residents, I am not sure how to accomplish this in time to protect residents. See *infra* notes 390–400 and accompanying text.

<sup>36</sup> See *infra* notes 410–15 and accompanying text.

<sup>37</sup> See *infra* notes 413–16 and accompanying text.

including narrow, piecemeal legislative goals which add confusion and complexity to the Bankruptcy Code.<sup>38</sup> Ultimately, however, Part V favors amending the Bankruptcy Code to protect CCF residents, as a necessary means of making these facilities safe, efficient investments for people who want to use them.<sup>39</sup>

## II. UNIQUE FINANCIAL ISSUES FACING LIFE CARE PROVIDERS

In 1900, only twenty-five percent of Americans lived to be over sixty-five.<sup>40</sup> By 1985, seventy percent of the population reached age sixty-five.<sup>41</sup> This number is increasing, and as a result, the number of elderly persons living in America is at an all time high.<sup>42</sup>

Although extensive efforts have been made to reduce aging and even cure the causes of aging and death,<sup>43</sup> nothing has worked so far, leaving each of us with a vested interest in issues related to aging. Not surprisingly, as we age we become even more interested in how we will get along toward the end of our lives.<sup>44</sup> As the population has aged in the past two centuries, society has changed in many other ways as well.<sup>45</sup> Many adult children no longer live near their parents, and few are willing or able to care for aging parents in their increasingly

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<sup>38</sup> *See id.*

<sup>39</sup> *See id.*

<sup>40</sup> *See Kapp, supra* note 1, at 720.

<sup>41</sup> *See id.*

<sup>42</sup> *See* Lisa Stearns et al., *Continuing-Care Retirement Communities: Issues in State Regulation*, 8 ST. LOUIS U. PUB. L. REV. 245, 245 (1989). By the year 2020, the elderly population is expected to double to 51.4 million. *See id.*

<sup>43</sup> From facelifts to anti-aging supplements to cryonics suspension, there is no end to the efforts in which society will engage to stay young, or avoid death altogether. For a fascinating look at all these efforts, see Life Extension Foundation Web Page, (visited Mar. 29, 2000), <<http://www.lef.org/index.shtml>>.

<sup>44</sup> *See id.* We have plenty of reason to be concerned. Economically there are unlikely to be enough resources, public or private, to care for this growing population, and as this growth exceeds the growth of the population in general, there will be fewer workers to support this aging population. *See id.*; *see also* ADVISORY COUNCIL ON SOCIAL SECURITY, *THE FINANCING AND DELIVERY OF LONG-TERM CARE SERVICES: A REVIEW OF CURRENT PROBLEMS AND POTENTIAL REFORM OPTIONS* 3 (1991).

<sup>45</sup> *See* Christine A. Semanson, *The Continuing Care Community: Will It Meet Your Client's Changing Needs?*, DET. C.L. REV. 771, 772 (1990).

busy lives.<sup>46</sup> Moreover, many people choose not to have children at all, leaving them without offspring to provide caretaking services for them in their old age.<sup>47</sup>

These factors, among others, have led to the proliferation of CCFs,<sup>48</sup> which provide elderly persons who can still live independently with a unique form of security.<sup>49</sup> Typically, CCFs obtain a large lump sum amount from residents who live independently in an apartment, but contract for the right to be transferred to a nursing homelike environment within the same facility when their health deteriorates.<sup>50</sup> While the residents continue to pay for the apartment and whatever meals and extra services they have contracted for, paying a large up front lump sum fee ensures the resident that they will have a place to live, with full nursing care provided, for the rest of their lives.<sup>51</sup> While these housing

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<sup>46</sup> See *id.* at 774. Today's modern American family is extremely mobile, leaving many elderly people without anyone geographically close upon whom they may rely for care. See *id.* at 772.

<sup>47</sup> See Stearns et al., *supra* note 42, at 253 (noting that 34% of CCF residents in 1989 did not have children).

<sup>48</sup> In 1986, there were 600–700 CCFs serving 100,000–200,000 residents. See STEARNS ET AL., *supra* note 42, at n.11 (citing Eileen J. Tell et al., *New Directions in Life Care: An Industry in Transition*, 65 MILBANK Q. 551–52 (1987)). At the time, it was predicted that by the late 1990s there would be over 1,500 CCFs with over 450,000 residents. See *id.* at 247. This proliferation of CCFs has resulted in a similar proliferation of writing about CCFs. See Michael D. Floyd, *Should Government Regulate the Financial Management of Continuing Care Retirement Communities?*, 30 ELDER L.J. 29, 29 n.1 (1993) (citing more than 30 sources written about CCFs). Most scholars who have written about these facilities call them, to my mind euphemistically, continuing-care retirement communities, or CCRCs. I prefer CCFs because these are businesses, not merely “communities” of individuals. See *id.*; see also Joan E. Fairbanks, *Lifetime Care Contracts: Are Senior Citizens Putting All Their Eggs in One Basket?*, 4 PROB. & PROP. 4 (1990); STEARNS ET AL., *supra* note 42, at 246 (quoting William B. Fisher, *Continuing Care Retirement Communities: A Promise Falling Short*, 8 GEO. MASON L. REV. 47, 47 (1985)).

<sup>49</sup> See Semanson, *supra* note 45, at 775. The goal of the CCF community or “Life Care” community is to provide an environment in which elderly residents can maintain their highest level of independence for as long as possible and also be sure progressive nursing care will be available for them when they need it. See *id.* The arrangements also ensure that elderly persons will have a place to live where they will be taken care of for the rest of their lives. See Fisher, *supra* note 48, at 48.

<sup>50</sup> See Fisher, *supra* note 48, at 47; Floyd, *supra* note 48, at 37–38. Floyd reports that as of 1988, median entrance fees for CCFs ranged from \$32,800 for a studio apartment to \$85,000 for units larger than two bedrooms. Such fees are undoubtedly far higher today. See also Semanson, *supra* note 45, at 775. As commentators have noted, charging a higher up front fee allows the older person to live independently now and also to “age in place.” STEARNS ET AL., *supra* note 42, at 246.

<sup>51</sup> See Fisher, *supra* note 48, at 49 (noting that “the central purpose and promise of [CCFs] is that they will provide security and certainty for the resident through the end of his or

arrangements pose a number of problems, they can be very attractive to people who are not sure they can maintain their lifestyle in the family home. The peace of mind that comes from independent living and guaranteed future nursing care is hard to beat, and is a good way to insure against unpredictable risk.<sup>52</sup>

The services and facilities provided by CCFs vary greatly, but many offer a combination of housing, health care, and insurance.<sup>53</sup> While the people who sign CCF contracts cannot be stereotyped, they tend to be over seventy-five, educated, somewhat well off, and more often than not, female.<sup>54</sup> While the services that such individuals seek vary, individuals often look for things other than nursing care, including intermediate services, such as assistance with everyday tasks or communal living, without around-the-clock nursing care.<sup>55</sup>

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her life"); Semanson, *supra* note 45, at 775.

<sup>52</sup> See Floyd, *supra* note 48, at 35-36; see also STEARNS ET AL., *supra* note 42, at 247 (noting that the CCF contract can act as a hedge against impoverishment due to unforeseen long-term care costs).

<sup>53</sup> See Stearns et al., *supra* note 42, at 246. CCFs are typically defined as retirement facilities that provide shelter, care, and services, including nursing home services, for as long as the resident lives in the facility. Residents receive services in return for a one-time entrance fee (generally between \$15,000 and \$200,000) and monthly fees of \$250 to \$1,300. Today, fees are far higher. See *infra* note 60.

<sup>54</sup> See Stearns et al., *supra* note 42, at 253-54. These authors describe the typical CCF user under the following prototype:

[T]he prototype [CCF] resident is an independent, female, former school teacher living alone. These essential characteristics are drawn from the following data on recent residents of [CCFs]. More than seventy-five percent of [CCF] consumers are over seventy-five years of age; just under fifty percent are married; seven percent have never been married; over seventy percent are women; thirty-four percent have no children; sixty-five percent have no children living near the prospective [CCF]; over ninety-five percent are white; forty-eight percent have been professionals; seventeen percent have been managers or proprietors; twenty-three percent have been sales or clerical workers; six percent have been primarily housewives; forty-eight percent are college graduates; forty-nine percent have an annual income of over \$30,000; eighty-six percent feel it is unacceptable to depend on family; and eighty-seven percent feel confident about their ability "to make plans work."

*Id.* at 253-54 (citing Morris et al., *Characteristics of Residents of Continuing Care Retirement Communities* 2-3, paper presented at the 39th Scientific Meeting of the Gerontological Society of America, Chicago (Nov. 1986) (available from Columbia Law School Legislative Drafting Research Fund)) (presenting data that represent the response rates of persons residing for less than a year in the CCFs sampled); Eileen J. Tell et al., *Assessing the Elderly's Preferences for Lifecare Retirement Options*, 27 GERONTOLOGIST 503, 503-08 (1987) (providing a profile of the typical CCF resident undifferentiated by length of residence).

<sup>55</sup> See Kathie M. McDonald, Note, *Residents' Rights in a Life Care Retirement Community: The Need for Improved Legislation*, 23 J. FAM. L. 583, 586 (1985). These



Other available services may include meals, housekeeping services, transportation, and social activities.<sup>56</sup>

The "insurance" component in such a package is one of the most desirable attributes of the arrangement.<sup>57</sup> Most residents are guaranteed some future level of nursing care, ranging from contracts that provide for full nursing care into the future with little or no increase in the monthly payments, to guaranteed nursing care up to a certain dollar cap, to virtually no nursing care except that the care paid for in cash at the time that services are rendered.<sup>58</sup>

Continuing-care, however, is a financially complicated business. Financial vulnerability is a very real concern in this field, which has been notorious for financial failure.<sup>59</sup> These failures are easily explained by the structure of the financial relationship between the CCF and its residents. Residents are charged up front based on physical exams and amortization schedules.<sup>60</sup> These fees are

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facilities recognize that retirement occurs in two phases. First, there is a phase of healthy and productive independent living, followed by a phase in which the elderly become more dependent on outside assistance for everyday tasks, as well as medical needs. *See id.* During the second, or assisted-living phase, three levels of skilled care have been recognized in the literature: (1) "skilled nursing care," which involves the most expertise and is offered by skilled professionals, twenty-four hours a day; (2) "intermediate care," which provides health related services on a less than twenty-four hour basis; and (3) "personal care," which typically involves only assistance with daily tasks, such as meals, dressing, bathing, and other personal needs. *See id.* at n.17.

<sup>56</sup> *See* HENRY E. WINKLEVOSS & ALWYN V. POWELL, CONTINUING CARE RETIREMENT COMMUNITIES: AN EMPIRICAL, FINANCIAL, AND LEGAL ANALYSIS 54 (Richard D. Irwin ed. 1984); *see also* Fisher, *supra* note 48, at 48 (noting that some CCF communities also offer excursions, films, lectures, and religious services).

<sup>57</sup> *See* Mark R. Greene, *Life Care Centers—A New Concept in Insurance*, 48 J. RISK & INS. 403, 419 (1981).

<sup>58</sup> *See* Stearns et al., *supra* note 42, at 246–47 (noting that in 1987, about 64% of all CCFs charged an up front fee and thereafter guaranteed certain long-term, continuing-care services at little or no extra cost).

<sup>59</sup> According to one 1988 study of 109 facilities, more than 40 reported either a negative net income or a negative net worth. *See* Hirsh S. Ruchlin, *Continuing Care Retirement Communities: An Analysis of Financial Viability and Health Care Coverage*, 28 GERONTOLOGIST 156, 159 (1988). As one would expect, facilities that offered full nursing care, at essentially one up front cost, were in the worst financial condition. *See id.* In a well-known magazine article, one author noted that of the 50 CCFs that were financed with tax exempt bonds since 1980, 10% defaulted on their debts and 14% failed to meet their occupancy rates. *See* Denise M. Topolnicki, *The Broken Promise of the Life-Care Communities*, MONEY, April 1985, at 150.

<sup>60</sup> Actually, there are a number of different financial models through which life care can be arranged or "purchased," though most arrangements do include an up front fee, that ranged from \$15,000–\$200,000 in 1990. *See* Fairbanks, *supra* note 48, at 6. A study done at the University of Pennsylvania in 1980, concluded that the range of up front fees at that time was

used for a number of things, including building a facility for new CCFs and improving the existing facilities for established CCFs.<sup>61</sup> How these entrance funds are managed will in large part determine the financial health of the facility.<sup>62</sup> Another factor in financial health is the balance between the up front fees (typically ranging from \$40,000–\$250,000) and the monthly fees.<sup>63</sup> Unless investments are extremely successful, large up front fees cause the facility to rely

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\$1,000–\$187,000, with \$35,000 being average. See WINKLEVOSS & POWELL, *supra* note 56, at 34. Like most of life's expenses, these entry fees continue to increase; the current average up front fee for entrance into a California CCF is over \$800,000. See Telephone Interview by Brian Colón, research assistant of Professor Nathalie Martin, with Bill Woodward, Chief, Continuing-care Contracts Branch, Continuing-care Liscensing Division, State of Cal. Dep't of Social Servs. (July 23, 1999). In Connecticut, fees range from \$39,818 to \$455,900. See ELDERLY SERVS. DIV., CONNECTICUT DEP'T OF SOCIAL SERVS., CONTINUING CARE RETIREMENT COMMUNITIES V (1997).

While it is recognized that using actuarial information is critical to charging residents a sufficient up front fee, see Stearns et al., *supra* note 42, at 256, CCFs tend to misuse this information. See WINKLEVOSS & POWELL, *supra* note 56, at 235–37.

<sup>61</sup> See Floyd, *supra* note 48, at 37 (noting that entrance fees may provide capital to build a new facility or to upgrade an existing facility). I found it surprising to learn that CCFs could use up front fees to finance new facilities, assuming these fees had to be invested for the future healthcare needs of residents. It seemed far more appropriate to finance new construction through the more typical means, such as conventional or tax free bonds. Apparently, however, this industry is considered too risky to generate much interest in the lending or tax free bond markets. See STEVEN R. EASTAUGH, FINANCING HEALTH CARE 181 (1987). Moreover, as it turns out, most states require very little reserves from the up front fees, and only 20 states require any reserves at all. See *infra* notes 189–92 and accompanying text.

<sup>62</sup> As Professor Floyd notes in his extensive article on the regulation of CCFs, a portion of the up front fees “may go to fund the resident's future nursing care needs.” Floyd, *supra* note 48, at 37. This is surely an understatement. Under the most typical model, in which most of the fees are paid up front, it is absolutely critical to a CCF's survival that it set aside a large percentage of the up front fees for residents' future long term care. See *infra* notes 189–92 and accompanying text.

<sup>63</sup> While not all CCFs charge a monthly fee, in addition to the up front fee, a failure to charge such a fee should raise a “red flag” for prospective residents. See Fairbanks, *supra* note 48, at 6. Regardless of how accurate an actuarial analysis is, inflation and other unpredictable factors require that a facility be able to make adjustments to its cash flow based on future circumstances. See *id.* CCFs can, to some extent, make up for insufficient up front charges by increasing their monthly charges, which ranged in 1989, from \$695 to \$1,000, depending on the size of the unit. See *id.* Of course, if monthly fees go up too much, residents will have lost one of the primary benefits of their CCF contracts, the ability to limit future expenses. See Floyd, *supra* note 48, at 38 (noting that “higher entrance fees reduce the risk that increasing monthly fees in the future will outstrip residents' future ability to pay”).

Out of fairness to residents, some states regulate fee increases by restricting the frequency and the increments of such increases, similar to the way rent control statutes control costs in landlord-tenant situations. See Fairbanks, *supra* note 48, at 6.

on resident turnover to stay afloat.<sup>64</sup> The CCFs' financial goal should be to set money aside from entrance fees to meet the future needs of these residents.<sup>65</sup> In the past, however, many facilities have used the proceeds of new contracts to meet current obligations to existing residents.<sup>66</sup>

Another potential financial problem CCFs have faced is vastly overestimating the demand for their contracts.<sup>67</sup> Reduced sales figures cause financial failures similar to those experienced in real estate developments.<sup>68</sup> Similarly, if monthly operating expenses are underestimated and undercharged to residents, cash flow problems emerge.<sup>69</sup> Some homes also have drastically underestimated the cost of resident health care.<sup>70</sup> Finally, if turnover is less than

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<sup>64</sup> See Floyd, *supra* note 48, at 38.

<sup>65</sup> If CCFs are going to serve their populations, up front fees must be reserved or set aside for the future needs of residents. See Howard A. Winklevoss, *Continuing Care Retirement Communities: Issues in Financial Management and Actuarial Prediction*, in CONTINUING CARE RETIREMENT COMMUNITIES: POLITICAL, SOCIAL, AND FINANCIAL ISSUES 57, 59 (Ian A. Morrison et al., eds. 1986). Fifteen states require that a portion of the up front fees be placed in reserve for future use, so they are not depleted by short term construction and other needs. See *infra* notes 189–92 and accompanying text. In many states, pre-occupancy payments must be escrowed and released according to a set schedule. See *id.* These statutes may not sufficiently protect residents, however, because the required reserves are far too small and moreover, the CCFs need not maintain the reserves for very long. See *id.*

Moreover, very few state statutes actually require that reserves be set up to handle future obligations. See *infra* notes 189–92 and accompanying text. While the American Association of Homes for the Aging ("AAHA") recommends that CCFs establish a reserve fund equal to the annual principle and interest payments on all debt service, plus enough to cover two to six months of operating costs, only fifteen state statutes require any reserves whatsoever. See *id.*

<sup>66</sup> While several of such instances are noted in Fisher, *supra* note 48, at 47, the most notorious case involving a failure to reserve is *Matthews v. Pacific & S.W. Annual Conference of the United Methodist Church (In re Pacific Homes)*, 1 B.R. 574 (Bankr. C.D. Cal. 1979). Pacific Homes was a CCF originally formed to take care of retiring Methodist ministers. It eventually expanded its facilities to serve almost 1900 people in seven facilities located in four states. Residents could pay for their services in one of three ways: total up front cash fee, transfer of all assets, or up front fee plus a monthly fee. See Fisher, *supra* note 48, at 50. In the vast majority of the CCF contracts in place, residents paid no monthly fee, making the facilities dependent upon reserves and sound investments for continued viability. Thus, when Pacific Homes began directing its capital toward expansion, speculative investment, and financing its resulting operating losses, its financial condition crumbled. It began entering into new CCF contracts to finance not just operating expenses, but also losses, creating a "Ponzi scheme" that ultimately resulted in bankruptcy. See Winklevoss, *supra* at 58.

<sup>67</sup> See Topolnicki, *supra* note 59, at 152, 154–55.

<sup>68</sup> See Floyd, *supra* note 48, at 66.

<sup>69</sup> See *id.*

<sup>70</sup> See *id.*

one estimates, revenues will be lower than projected.<sup>71</sup> All these factors must be monitored constantly by facilities, and both entry fees and monthly fees must be adjusted accordingly.<sup>72</sup> Of course, if these fees become too high to be competitive, this will affect the viability of the facility as well.<sup>73</sup>

While an underpriced facility is no bargain, paying dearly for a continuing-care contract does not guarantee adequate future care. Media coverage of CCFs has focused primarily on "worst case scenarios."<sup>74</sup> While the fraud involved is probably not as prevalent as the media makes it sound,<sup>75</sup> there are many things that residents should be concerned about when entering into a continuing-care contract.<sup>76</sup> They must first understand the economics of prepaying for any service. To remain viable, a facility must set aside a portion of the funds received to care for residents in later years, when resident health care costs are far higher.<sup>77</sup> The facility cannot see surplus cash as profits, given these costs, which are essentially defined financial obligations.<sup>78</sup> As Dr. Winklevoss, an expert on CCFs, has aptly explained:

A major problem in the financial management of a life care community is the very deceptive nature of the income and cash flow of these communities over the first decade and a half of their existence. When you open up a community, you get a tremendous influx of funds in the form of entry fees, while the health care utilization of the residents admitted does not accelerate for about 10 or 15 years. What that means is that the overseers of that community have to have enough patience and fortitude to reserve the monies that they are receiving during the first 10 years until there is an inevitable increase in health care utilization. Lack of reserves has been a big problem. As was noted above,

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<sup>71</sup> Sarah Williams, *Long-Term Care Alternatives: Continuing Care Retirement Communities*, in *CONTINUING CARE RETIREMENT COMMUNITIES: POLITICAL, SOCIAL & FINANCIAL ISSUES* 15, 21, 40 (Ian A. Morrison et al., eds. 1986); see also Floyd, *supra* note 48, at 40.

<sup>72</sup> See Williams, *supra* note 71, at 22; see also Floyd, *supra* note 48, at 41.

<sup>73</sup> See Topolnicki, *supra* note 59, at 155.

<sup>74</sup> *Id.* at 152-56 (showcasing the most flagrantly fraudulent CCF stories); see also Michael Moss, *For Retirees, Moving into 'Continuing Care' Offers No Guarantees*, WALL ST. J., Oct. 8, 1998, at A1 (reviewing numerous problems in CCFs, including a discrepancy between advertising and contracts, residents being forced from their apartments into the nursing wing due to financial motivations, and lack of resident input over how entrance fees are spent).

<sup>75</sup> Other than the *Pacific Homes* case, see *Matthews v. Pacific & S.W. Annual Conference of the United Methodist Church (In re Pacific Homes)*, 1 B.R. at 574 (Bankr. C.D. Cal. 1979) there are no reported cases of fraud in CCFs.

<sup>76</sup> See *infra* notes 183-99 and accompanying text.

<sup>77</sup> See *supra* notes 63-69 and accompanying text.

<sup>78</sup> See Winklevoss, *supra* note 65, at 59-61.

when communities start out they have quite a bit of money, health care utilization is low, and they run the finances of the community in such a way that the amount of money coming in equals the amount going out. Thus, a substantial hidden liability begins to build up. Then if they should have a minor adverse experience, such as a cash flow problem, they find out that there is a tremendous unfunded health care liability, which is very difficult to remedy financially.

A number of factors contribute to lack of reserves. First, generally accepted accounting principles (GAAP) are not adequate for the management of these communities if they are going to set fees to reserve for the long-term health care obligation. This does not imply that GAAP should not be used; certainly they should, but they are not adequate when running a "mini-insurance company." Both the pension and the insurance industries have already recognized this. Second, life care communities do not often have boards which have a lot of time to spend on finance issues, and often they do not understand the true nature of the financial commitment of a CCRC. Moreover, they tend to be offended if in the early years revenues exceed expenses. As soon as this happens, the board feels that it does not need to increase fees or suggests only a modest increase because it looks like the community is making a profit, and the last thing board members want to do is profit from the people they are trying to serve. Generally, GAAP accounting statements will show substantial profits every year during the first 10 years if the fees are correct. However, they are not really profits; they are funds that are going to be needed to support the health care obligation later on. But the combination of the deceptive nature of GAAP accounting, the non-profit aspect of the homes, and the lack of understanding that the health care guarantee is a deferred obligation that should be funded, causes communities to underprice themselves. If they are lucky enough to get through the first 15 years, then the chances are good that they can continue with revenues equaling expenditures, because everything will have reached a fairly steady state. Unfortunately in the last years, inflation has caused a lot of communities to be unable to get through the maturation period, and they have run into trouble.<sup>79</sup>

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<sup>79</sup> *Id.* at 59–60. Accounting dictates that revenues should match expenses and that when you have an expense stream that will escalate because of increased health care utilization, you can avoid having monthly fees increased by more than inflation. *See id.* Dr. Winklevoss goes on to note other problems with the way CCFs have traditionally done their accounting:

When you receive a \$50,000 entry fee, it is important for the board to set up the right mechanism by which that entry fee can be considered income to the community. If one considers that the entry fee is to be income in the first year, one is going to lose money every year thereafter. How can one assume that the \$50,000 entry fee is earned over the lifetime of the individual? Half of the communities earn it over the life expectancy of the individual. If a person is going to live 15 years, they will receive their income stream at the rate of 1/15 of the \$50,000 per year. Half the people are going to live beyond the life expectancy, a period during which their care will be more expensive. So if you earn all of the money up until a person's life expectancy, obviously you have earned that money too

Residents need a way of obtaining necessary data regarding how funds are reserved, so they can weigh the relative financial strength of various facilities.<sup>80</sup> They also need some means of determining the relative risks of fraud and mismanagement.<sup>81</sup> Much of this need, however, is a pipe dream.<sup>82</sup> Most residents have no access to truly relevant information in this regard and lack the capacity to make meaningful comparisons between facilities.<sup>83</sup> Information is asymmetrically distributed in favor of CCFs, and typically the best prospective residents can do is compare costs.<sup>84</sup> Yet this could result in making the wrong

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fast. The groups of communities surviving out there are the ones that have recognized that this is a problem. They earn the entry fee over a longer period than life expectancy. However, when they do this, they must recognize that they violate the fundamental principle of management-accounting which dictates that your revenues should match your expenses and that when you have an expense stream that will increase because of increased health care utilization, you can avoid having monthly fees increased only by earning a very small portion of the entry fee initially and then by gradually increasing the amount. To date, no communities seem to be earning entry fees correctly. Thus, they are all in the unfortunate position of earning what looks like a profit. Since boards of directors (of nonprofit organizations) do not want to make a profit, they do not pass proper fee increases on to residents, and they start creating an unfunded health care liability.

*Id.* at 60–61; *see also* Ruchlin, *supra* note 59, at 160 (reporting that in a 1983 study, 1/3 of all CCFs studied had either a negative net income or a negative net worth, and that 18.4% of the sample had both a negative net worth *and* a negative net income).

<sup>80</sup> *See* Floyd, *supra* note 48, at 44–45.

<sup>81</sup> *See id.*; *see also* Winklevoss, *supra* note 65, at 62 (noting how difficult it is to predict whether a CCF will be a financial success or a financial failure).

<sup>82</sup> First, there is absolutely no uniformity from state to state, or even from facility to facility, regarding financial reporting requirements, or the actual use of funds paid up front to a facility. *See* Semanson, *supra* note 45, at 785. Second, given how incredibly complicated these arrangements are, it is doubtful that the average retiree could understand all of the disclosures and financial information in any event. *See* Fairbanks, *supra* note 48, at 4 (describing the typical amount of paper involved in a CCF transaction, as well as the reasons elderly persons are drawn to such arrangements).

<sup>83</sup> *See* Floyd, *supra* note 48, at 44. As Professor Floyd explains, given the complexity of these contracts, providers of CCF services are much more likely to have relevant information about the industry than prospective residents will have. *See id.*

<sup>84</sup> *See id.* Professor Floyd explains the risk of relying only on price in choosing a CCF:

[U]sing a hypothetical market for automobiles . . . when goods of varying grades are offered and buyers' expectations about the quality of the goods offered are lower than that of sellers due to the seller's superior knowledge, a breakdown may occur in the market and trades may cease. In effect, the inferior products drive the better products out of the market because consumers cannot tell the difference and are only willing to pay the price of a "bad" product.

choice based on data that is too limited.<sup>85</sup>

The financial structure of these contracts also creates perverse incentives.<sup>86</sup> As Professor Michael Floyd noted in his comprehensive article on the financial regulation of CCFs, resident turnover is the only means of drastically increasing revenues.<sup>87</sup> Thankfully, the relatively healthy and youthful residents in these communities can protect somewhat against the macabre possibilities for raising cash in these instances.<sup>88</sup>

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*Id.* at 44–45. Thus, it is necessary to provide consumers with information that will cause them to pay the higher price for the better (presumably more financially stable) CCF product.

<sup>85</sup> It is difficult to determine what kind of information should be required, and of that information, which is most valuable. Among the types of disclosures required by various states are statutes attempting to illuminate the financial status of new facilities, which must require:

[T]he anticipated sources of funding and their application; the financial liability of sponsors and affiliates; the planned expenditures on items such as legal counsel, marketing services, and land; the nature of financing arrangements; and the estimated start up funds. Assessment of the financial viability of ongoing facilities is assisted by additional disclosures of: the reserves maintained; recent balance sheets and income statements; the results of actuarial calculations; the results of forecasting studies; the history of fee increases; the level of participation in Medicare and Medicaid programs; and the changes in ownership or management.

Stearns et al., *supra* note 42, at 251. While one can get a feel for management's competence by how well they fulfill any applicable disclosure requirements, *see id.*, it is unclear how much of this information is actually valuable. Clearly the most important information relates to the level of reserves the facility maintains. Too much information could be overwhelming. Moreover, no amount of information can actually predict the future. As one commentator has noted, no one, no matter how knowledgeable, can assess the feasibility of a particular facility. *See* Winklevoss, *supra* note 65, at 63. The best one is able to do is to check the reserve policies, check the Better Business Bureau for complaints about the facility, and see how well the facility has predicted its occupancy rates. Accurate occupancy rates, combined with conservative reserve policies, predict success better than any other factors. *See id.* at 62–63.

<sup>86</sup> *See* Floyd, *supra* note 48, at 51–52. These perverse incentives are present even outside of bankruptcy. *See id.*

<sup>87</sup> *See id.* at 52. As Professor Floyd notes, because death is virtually the only way to raise additional entry fees, this could induce a desperate management to provide less than adequate care or to even "hasten the demise of residents" in order to get the double benefit of reducing health care costs for this individual while at the same time earning another entrance fee. *Id.*

<sup>88</sup> *See id.* As Professor Floyd has noted:

CCRC residents are in a position to monitor the care they receive as well as that given to their friends in the community. Furthermore, residents have a vested interest in monitoring the performance of the community's nursing facility because the residents are likely to be future consumers of its services.

Other factors also support a need for regulation.<sup>89</sup> For many residents, the large sum required under these contracts represents the last major financial decision they will make.<sup>90</sup> There will often be few resources left after this contract is executed to make up for a poor choice.<sup>91</sup> Additionally, unlike the purchase of a home or condominium, residents do not obtain a fee interest in their homes.<sup>92</sup> They receive only the equivalent of a license to occupy the premises as long as monthly fees are remitted.<sup>93</sup> Generally, then, residents have no recognized property interest in their "home," and their interests are subordinate to those of all secured creditors and even some unsecured creditors.<sup>94</sup> As will be discussed in subsequent sections of this Article, this

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*Id.* Thus, residents can rely on a type of continuing buddy system to see that they are treated fairly in the future, an option most nursing home residents do not have.

<sup>89</sup> See William A. Wines, *The Long March to Bildisco and the 1984 Bankruptcy Amendments: Establishment of a Limited Right to Reject Collective Bargaining Agreements*, 20 GONZ. L. REV. 187, 221-22 (1985) (discussing how Marathon crippled the bankruptcy system and how there was a desire to make the system as credible as possible in light of the confusion). Virtually every scholar who has written about CCFs and regulation, except one, has recommended more regulation. See, e.g., Fisher, *supra* note 48, at 59-60; McDonald, *supra* note 55, at 591; Stearns et al., *supra* note 42, at 248-49. But see Floyd, *supra* note 48, at 33-35.

<sup>90</sup> See Fisher, *supra* note 48, at 49 (noting that CCF bankruptcies are disturbing because the central purpose and promise of CCFs is to provide security and certainty for the rest of a person's life); see also Floyd, *supra* note 48, at 52; McDonald, *supra* note 55, at 588-89 (stating that "[t]he life savings of elderly persons have been lost under life care contracts which refuse refunds even upon discharge of the resident. Moreover, the possibility of the life care provider's bankruptcy is an ever-present risk.").

<sup>91</sup> See Floyd, *supra* note 48, at 45, 52.

<sup>92</sup> See *id.* at 46. Maine's continuing-care statute provides that CCFs can sell condominiums, therefore some residents in Maine may own a condominium at their facility. See ME. REV. STAT. ANN. tit. 24-A, § 6207 (West 1989). Vermont's statute also infers that an ownership interest in CCF real estate is possible. See VT. STAT. ANN. tit. 8, § 8005(d)(13) (1993). This would certainly be the exception to the rule, however, and if the contract is silent on the issue, the resident gets no ownership interest in the facility's real estate.

<sup>93</sup> See Eastaugh, *supra* note 61, at 177-78. It is important for residents to understand that the payment of the up front fee does not provide them with any ownership interest in their CCF, but rather only with a license to occupy the premises. See *id.* at 178. This interest is not even equal to a leasehold interest, which is at least a recognized interest in property. See *Upland Euclid, Ltd. v. Grace Restaurant Co. (In re Upland/Euclid, Ltd. Restaurant Co.)*, 56 B.R. 250, 252 (B.A.P. 9th Cir. 1985) (stating that lessor cannot deprive lessee of "possessory property interest in the leased premises"); see Floyd, *supra* note 48, at 46.

<sup>94</sup> See Floyd, *supra* note 48, at 46; see also *infra* notes 319, 328-35 and accompanying text.



creates very unfair results for residents upon insolvency, particularly in federal bankruptcy cases.<sup>95</sup>

These concerns have led to an extensive maze of state regulations in the area of life care contracts, the prototypes of which are discussed throughout this Article.<sup>96</sup> Many attributes of these statutes are preempted by the Bankruptcy Code after a bankruptcy is filed, and others are voidable under particular provisions of the Bankruptcy Code.<sup>97</sup> The financial requirements and disclosure statutes, however, pose no such problem.<sup>98</sup> Some economists question whether these regulations actually solve any problems and also believe their costs outweigh their benefits.<sup>99</sup> As an alternative, one scholar has suggested that we let market alternatives protect citizens from harm, rather than continue to regulate this industry.<sup>100</sup> According to this scholar, industry accreditation, rating systems, and increased training for CCF managers and financial planners could be more beneficial than regulation, which has failed to uncover the most flagrant frauds.<sup>101</sup>

I remain unconvinced. Given the unique costs to residents and perverse incentives of CCF management, I believe some regulation is necessary. The way states have gone about regulating CCFs, however—piecemeal and erratically—continues to cause problems, particularly in the face of federal bankruptcy laws.<sup>102</sup>

### III. BALANCING BANKRUPTCY CODE SUPREMACY AND FEDERALISM: WHO HAS THE RIGHT TO CONTROL CCF INSOLVENCIES, THE STATES OR THE BANKRUPTCY COURTS?

Under the Supremacy Clause of the United States Constitution, the

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<sup>95</sup> See *infra* notes 284–405 and accompanying text.

<sup>96</sup> See *infra* notes 169–220 and accompanying text.

<sup>97</sup> See *id.*

<sup>98</sup> See *infra* notes 171–220 and accompanying text.

<sup>99</sup> See, e.g., Floyd, *supra* note 48, at 59–74.

<sup>100</sup> See *id.* at 53–59. Professor Floyd discusses various market alternatives that may work to protect citizens from harm, including: (1) industry self-accreditation, with standards of accreditation based on administration, resident life, finance, and health care; (2) the development of rating programs that would identify degrees of quality, which would allow consumers to make initial evaluations and, if the rating criteria were raised over time, would encourage continuing improvements in the industry; and (3) facilities entering into insurance contracts to pool the risks they face and protect their solvency. See *id.*

<sup>101</sup> See *id.* at 61–63.

<sup>102</sup> See *infra* notes 169–283 and accompanying text.

Bankruptcy Code supercedes all state laws in the area of bankruptcy.<sup>103</sup> Courts have held that any state law that conflicts with the provisions or purposes of the Bankruptcy Code is preempted by it,<sup>104</sup> unless the state law protects the health and welfare of its citizens.<sup>105</sup> Other than in the areas of criminal law and environmental law, courts have been vigilant in protecting bankruptcy rights over virtually all state statutes that come in conflict with the Bankruptcy Code, either directly or indirectly.<sup>106</sup>

Many provisions contained in CCF statutes are preempted by the Bankruptcy Code and thus unenforceable in bankruptcy.<sup>107</sup> Some are simply not enforceable during the pendency of the case, but are otherwise enforceable and very valuable.<sup>108</sup> Others are entirely unenforceable in bankruptcy, are not relevant otherwise, and mislead citizens about their extent of protection under applicable state law.<sup>109</sup> Other provisions may or may not be enforceable and present issues that have not yet been decided by courts.<sup>110</sup> These statutes raise many unanswered questions. Are states aware of the Supremacy Clause and the provisions of the Bankruptcy Code when they enact legislation? Are they trying to make law, or simply to provide for future changes in the law? Do they know which of these provisions are enforceable and which are not? This Part reviews bankruptcy supremacy and preemption, then reviews various provisions in CCF statutes to determine which statutes survive a supremacy analysis.

### *A. Supremacy and the History of the Bankruptcy Code*

It is unclear why the area of debt and credit became a matter of federal law. While Congress was permitted by the Constitution to enact a uniform system of bankruptcy laws as early as 1800, it did not do so until the Bankruptcy Act of

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<sup>103</sup> U.S. CONST. art. VI, § 2. The Supremacy Clause to the Constitution provides that:

This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.

*Id.*

<sup>104</sup> See *infra* notes 111–22 and accompanying text.

<sup>105</sup> See *infra* notes 144–68 and accompanying text.

<sup>106</sup> See *infra* notes 123–68 and accompanying text.

<sup>107</sup> See *infra* notes 169–283 and accompanying text.

<sup>108</sup> See *infra* notes 171–99 and accompanying text.

<sup>109</sup> See *infra* notes 200–36 and accompanying text.

<sup>110</sup> See *infra* notes 237–83 and accompanying text.

1898, when it finally enacted a comprehensive bankruptcy law that applied to both merchants and individuals, and to both voluntary and involuntary bankruptcy cases.<sup>111</sup>

While state insolvency statutes remained intact alongside the Bankruptcy Act of 1898 for a brief time, in 1929 the Supreme Court invalidated a state statute that provided for a limited bankruptcy discharge because federal law preempted state law on this issue.<sup>112</sup> The Court reasoned that any other ruling would create intolerable confusion, not to mention inconsistency, and would improperly interfere with the federal Bankruptcy Act.<sup>113</sup> In 1971, in *Perez v. Campbell*,<sup>114</sup> the Supreme Court reaffirmed its commitment to bankruptcy supremacy, again invalidating a state law that interfered with the bankruptcy discharge provisions. As the Court reasoned, federal bankruptcy law must be protected from state interference, regardless of the purpose behind the state statute.<sup>115</sup> The Arizona statute in question excepted from discharge any judgment obtained in connection with an automobile accident.<sup>116</sup> The Supreme Court held that because this state statute interfered directly with the discharge

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<sup>111</sup> See Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5, 13–14 (1995). Professor Tabb indicated that Charles Pickney of South Carolina authored the Bankruptcy Clause of the Constitution, Article I, Section 3. See *id.* at 13. Very little discussion or apparent thought went into the Clause, and the only clue we have as to why it was enacted can be gleaned from the following remark by James Madison:

The power of establishing uniform laws of bankruptcy is so intimately connected with the regulation of commerce, and will prevent so many frauds where the parties or their property may lie or be removed into different states that the expediency of it seems not likely to be drawn into question.

*Id.*

<sup>112</sup> See *id.* at 13. The Bankruptcy Act was enacted after several unsuccessful attempts to come up with a comprehensive system. See Joseph Lamport, Note, *The Pre-emption of Bankruptcy Only Exemptions*, 6 CARDOZO L. REV. 583, 587–89 (1985).

<sup>113</sup> See *International Shoe Co. v. Pinkus*, 278 U.S. 261 (1929). As the Court stated:

The national purpose to establish uniformity necessarily excludes state regulation. It is apparent, without comparison in detail [of state and federal law] . . . that intolerable inconsistencies and confusion would result if that insolvency law be given effect while the national Act is in force. . . . States may not pass or enforce laws to interfere with or complement the Bankruptcy Act or to provide additional or auxiliary regulations.

*Id.* at 265.

<sup>114</sup> 402 U.S. 637 (1971).

<sup>115</sup> See *id.* at 651–52.

<sup>116</sup> See *id.* at 642.

granted by the Bankruptcy Code, it violated the Supremacy Clause and was thus invalid. According to the Court, a state statute is preempted whenever it "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."<sup>117</sup> As the Court reasoned, Congress' goal was to discharge the obligations of the debtor, and states cannot enact statutes that conflict with this goal.

In light of *Perez*, the law seemed to be that whenever a state statute interfered with the Bankruptcy Code in any way—in other words, interfered with its purposes or its implementation—the Bankruptcy Code preempted the state statute.<sup>118</sup> Since *Perez*, however, the Supreme Court has made it clear that this

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<sup>117</sup> *Id.* at 649. Interestingly, just before deciding *Perez*, the Supreme Court decided *Younger v. Harris*, a seminal case in federal jurisprudence in which the Supreme Court found that a federal court could not void a California criminal syndicalism statute on constitutional grounds. The Court found that it could not enjoin the enforcement of the statute, because such federal action would violate principles of comity and federalism, and would improperly intrude on a state court proceeding. *See Younger v. Harris*, 401 U.S. 37, 38–39, 41 (1971). According to the Supreme Court, there must be a great and immediate danger of irreparable harm for such an injunction to issue, and Harris had the ability to argue for a violation of his constitutional rights, in defense to the criminal charges. *See id.* at 46–49. Thus, no irreparable harm was present and the state statute had to be given full effect.

<sup>118</sup> In *Perez*, 402 U.S. at 637, in contrast to *Younger*, 401 U.S. at 37, the Supreme Court took an entirely different analytical approach. Justice Black, who also wrote for the Court in *Younger*, held that the Bankruptcy Act preempted a state statute that attempted to preclude a person from discharging in bankruptcy, any judgment rendered as a result of an automobile accident. *See Perez*, 402 U.S. at 642. According to Justice Black, to whom the court cites at length, the purpose of the Bankruptcy Act to provide debtors with a fresh start could not be frustrated by a state statute. According to Black, the state statute improperly hindered the accomplishment of a Bankruptcy Act goal, thus interfering with the Supremacy Clause. *See id.* at 649; *see also Duffey v. Dollison*, 734 F.2d 265, 267 (6th Cir. 1984) (holding that the Supremacy Clause dictates that a conflict between bankruptcy and state interests be resolved in favor of federal law); *Erlin Manor Nursing Home, Inc., v. Rate Setting Comm'n (In re Erlin Manor Nursing Home, Inc.)*, 36 B.R. 672, 677 (Bankr. D. Mass. 1984) (holding that if a state regulation conflicts with bankruptcy law, the regulation is invalid in the bankruptcy context); *Colin v. Fidelity Standard Mortgage Corp. (In re Fidelity Standard Mortgage Corp.)*, 36 B.R. 496, 499 (Bankr. S.D. Fla. 1983) (holding that bankruptcy law is unrestricted and paramount and will preempt state law on similar subject matters); *Layfield v. Director of Public Safety (In re Layfield)*, 12 B.R. 846, 850 (Bankr. N.D. Ala. 1981) (holding that the Director of the Public Safety Commission was without authority to suspend the debtor's license, to withhold it from the debtor, or to condition its return upon the requirement of purchasing special high-risk insurance—all as a violation of the "Fresh Start" doctrine); *Henry v. Heyison*, 4 B.R. 437, 442 (Bankr. E.D. Pa. 1980) (holding that Pennsylvania's Financial Responsibility Act subverted the Bankruptcy Code's policy of giving debtors a fresh start because it required bankruptcy debtors to take extra steps in order to obtain a driver's license); *Rutledge v. City of Shreveport*, 387 F. Supp. 1277, 1281 (W.D. La. 1975) (holding that a local regulation that dismissed plaintiff from his job as a police officer because he filed for bankruptcy was unconstitutional in that it

simple bright-line, "rock beats paper" analysis, is not applicable in every situation.<sup>119</sup> The issue is complicated by the interplay between concurrent state and federal statutory systems, each designed to achieve different—and often competing—goals.<sup>120</sup> Most scholars agree, however, that in all but the most unusual circumstances, federal statutes do invalidate competing state statutes on the same or similar subject matter, and that "within constitutional limits Congress may pre-empt state authority."<sup>121</sup> It is also well-accepted that preemption can be: (1) express, (2) implied by a federal regulatory scheme that is so pervasive it leaves no room for states to supplement the scheme, or (3) implied due to a direct, head-to-head conflict between state and federal law.<sup>122</sup>

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conflicted with federal bankruptcy law); *Grimes v. Hoschler*, 525 P.2d 65, 69–70 (Cal. 1974) (holding that certain sections of the state's Contractors License Law, which threaten a contractor with the loss of his license if his debts incurred as a contractor are discharged for less than their full amount in a bankruptcy proceeding, and which forbid the reissuance of a revoked license until the amounts of the discharged debts are paid in full, conflicts with the Bankruptcy Act and was therefore invalid under the Supremacy Clause of the United States Constitution).

<sup>119</sup> See *Kelly v. Robinson*, 479 U.S. 36, 47–53 (1986) (refusing to resolve all conflicts between state and federal law by preempting state law, and instead balancing the interests of both states and federal government).

<sup>120</sup> See Ellen E. Sward, *Resolving Conflicts Between Bankruptcy Law and the State Police Power*, 1987 WIS. L. REV. 403, 443–44 (noting the conflict in the context of environmental laws).

<sup>121</sup> Honorable William T. Bodoh & Michelle M. Morgan, *Inequality Among Creditors: The Unconstitutional Use of Successor Liability to Create a New Class of Priority Claimants*, 4 AM. BANKR. INST. L. REV. 325, 346 (1996) (citing *Pacific Gas & Elec. Co. v. State Energy Resources Conservation & Dev. Comm'n*, 461 U.S. 190, 203 (1983)). In *Pacific Gas*, the Court held that provisions in the 1976 amendments to California's Warren-Alquist Act, which conditioned the construction of nuclear plants on findings by a state commission that adequate storage facilities and means of disposal were available for nuclear waste, were not preempted by the Federal Atomic Energy Act of 1984. See *Pacific Gas*, 461 U.S. at 194–95. The Court found that the need for new power facilities, their economic feasibility, and rates and services, have characteristically been governed by the states. The Court reasoned that Federal interests were national security, public health, and safety. See *id.* at 207. The Court further concluded that the federal government occupies the entire field of nuclear safety concerns, while the California statute addresses economic concerns. Because the statute fell outside the occupied field of nuclear safety regulation, it was not preempted. See *id.* at 216.

<sup>122</sup> See Bodoh & Morgan, *supra* note 121, at 346; see also *Pacific Gas*, 461 U.S. at 203–04 (discussing express preemption and implied preemption due to a pervasive regulatory scheme); *Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta*, 458 U.S. 141, 153 (1982) (discussing implied preemption due to a pervasive regulatory scheme); *Jones v. Rath Packing Co.*, 430 U.S. 519, 525 (1977) (discussing both express and implied preemption); *Florida Lime & Avocado Growers, Inc. v. Paul*, 373 U.S. 132, 142–43 (1963) (discussing implied preemption resulting from a head-to-head conflict between state and federal law).

In *Louisiana Public Service Commission v. FCC*, the Supreme Court described

## B. Federalism and Supremacy

State interests that take priority over federal interests are often uniquely local concerns, things that cannot be legislated from far away or that have always been left to the states' domain.<sup>123</sup> The clearest example is criminal law.

In 1986, the Supreme Court clarified that it would not allow the Bankruptcy Code to run roughshod over state criminal laws. In *Kelly v. Robinson*,<sup>124</sup> the Court upheld a state statute requiring a bankruptcy debtor to pay criminal restitution fees to a state.<sup>125</sup> Mrs. Robinson had fraudulently received welfare benefits from the state and was required to reimburse the state under a purportedly criminal statute.<sup>126</sup> When she tried to discharge the debt in

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federal preemption as follows:

Preemption occurs when Congress, in enacting a federal statute, expresses a clear intent to preempt state law, when there is outright or actual conflict between federal and state law, where compliance with both federal and state law is in effect physically impossible, where there is implicit in federal law a barrier to state regulation, where Congress has legislated comprehensively, thus occupying an entire field of regulation and leaving no room for the States to supplement federal law, or where the state law stands as an obstacle to the accomplishment and execution of the full objectives of Congress.

476 U.S. 355, 368 (1986) (citations omitted).

There are also constitutional limitations on what federal statutes can impose on states, although these limits have not been fully articulated. See *Pacific Gas*, 461 U.S. at 203. The Court in *Pacific Gas* found it well established that within constitutional limits Congress may preempt state authority by so stating in express terms. See *id.* at 203. Preemption without explicit language is acceptable when there is no room for states to supplement the law because the act of Congress may touch a field in which the federal interest is so dominant that the federal system may be assumed to preclude enforcement of state laws on the same subject or because the object sought to be obtained by the federal law and the character of obligations imposed by it may reveal the same purpose. See *id.* at 203–04; see also *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, 87 (1982) (holding the existing bankruptcy court system unconstitutional because it attempted to vest the judicial power of the United States into non-Article III courts); Michael J. Donovan, Note, *Criminal Restitution and Bankruptcy Code Discharge—Another Case for Defining the Scope of Federal Bankruptcy Law*, 65 NOTRE DAME L. REV. 107, 122–23 (1989) (arguing that Congress' grant of power under the Bankruptcy Clause is necessarily limited by bankruptcy's jurisprudential role in history).

<sup>123</sup> See *infra* notes 144–68 and accompanying text.

<sup>124</sup> 479 U.S. 36 (1986).

<sup>125</sup> See *id.* at 53 (holding that because criminal proceedings focus on the states' interest in rehabilitating and punishing criminals, rather than a victim's desire for compensation, restitution orders fall within section 523(a)(7) of the Bankruptcy Code).

<sup>126</sup> See *id.* at 38–39.

bankruptcy, the bankruptcy court found the debt nondischargeable despite the Bankruptcy Code's broad discharge policies.<sup>127</sup> The appellate court reversed<sup>128</sup> and the Supreme Court reversed again,<sup>129</sup> finding that the criminal restitution obligations were not dischargeable in bankruptcy. While the Court relied in part on a specific Bankruptcy Code provision, section 523(a)(7), that arguably made the debt nondischargeable,<sup>130</sup> the Court also held that the state must be allowed to protect citizens by enacting and enforcing criminal statutes.<sup>131</sup>

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<sup>127</sup> See *id.* at 41; see also *id.* at 56–58 (Marshall, J., dissenting) (describing the broad discharge provisions of the Bankruptcy Code and denying that a state restitution statute could interfere with them).

<sup>128</sup> See *In re Robinson*, 776 F.2d 30, 33 (2d Cir. 1985), *rev'd*, *Kelly v. Robinson*, 479 U.S. 36 (1986). The Bankruptcy and District Court held that money Mrs. Robinson owed to the state was not technically a debt, but was some other type of obligation. See *Robinson v. Director, Office of Adult Probation (In re Robinson)*, 45 B.R. 423, 424–25 (Bankr. D. Conn. 1984). The Second Circuit disagreed, noting that Congress had intended to give “debt” the broadest possible meaning under the Bankruptcy Code and that all obligations of any kind were to be resolved through the bankruptcy proceeding. See *In re Robinson*, 776 F.2d at 34. The Second Circuit also rejected a tortured argument many courts had made to explain why this was not a debt or did not provide a “right of payment,” which defines a bankruptcy “claim.” See *id.* at 33–34. According to some courts, the Office of Adult Probation (or some other state office), rather than the crime victim, had the right to enforce the obligation. As long as the victim of the crime does not receive any payments directly from the debtor, then the obligation is not a debt and cannot be discharged. See *In re Johnson*, 32 B.R. 614, 616 (Bankr. D. Colo. 1983); *State v. Magnifico (In re Magnifico)*, 21 B.R. 800, 802–03 (Bankr. D. Ariz. 1982). Apparently, if the restitution is seen as a penalty and not a reimbursement to the state, it serves a deterrent purpose rather than a debt collection purpose and is not a debt. In reality, however, restitution serves more of a compensatory goal than a punishment goal. See Richard E. Laster, *Criminal Restitution: A Survey of Its Past History and An Analysis of Its Present Usefulness*, 5 U. RICH. L. REV. 71, 96 (1970).

<sup>129</sup> See *Kelly*, 479 U.S. at 43.

<sup>130</sup> See *id.* at 50 (quoting 11 U.S.C. § 523(a)(7) (1994)) (making nondischargeable any debt “to the extent such debt is for a fine, penalty, or forfeiture payable to and for the benefit of a government unit and is not compensation for actual pecuniary loss”). Since Mrs. Robinson was paying back the money she improperly received from welfare, it is hard to see why this is not “compensation for actual loss.” Deborah A. Ballam, *Kelly v. Robinson Revisited: Dischargeability of Restitution Obligations in Chapter 13 Bankruptcy Proceedings*, 34 ST. LOUIS U. L.J. 1, 35 n.14 (1989) (citing numerous authorities for the proposition that restitution is virtually always aimed at compensation rather than at rehabilitating the criminal); see also *Kelly*, 479 U.S. at 55 (Marshall, J., dissenting) (noting that by tying the amount of restitution to the amount of actual money Mrs. Robinson received from welfare, the state strongly suggested that the statutory goal is compensation).

<sup>131</sup> The Court stated that it was required to interpret the Bankruptcy Code with deference to federalism issues. See *Kelly*, 479 U.S. at 49. The Court further stated that the state's interest in administering their criminal justice system, free from federal interference, was one of the most powerful considerations affecting the *Robinson* decision and the Court's interpretation of

While the Court held that federalism concerns required that the state be allowed to enforce its criminal justice system, some scholars question whether these concerns can ever outweigh the power of the Supremacy Clause.<sup>132</sup> In fact, many lower courts that had considered the issue of discharging criminal restitution obligations held that these obligations were clearly debts dischargeable in bankruptcy, and that the statutes creating these obligations violate the Supremacy Clause.<sup>133</sup> The *Kelly* decision contains a powerful dissent by Justice Marshall, claiming that even if this were a "real" criminal statute that actually did protect citizens in some way, rather than simply filling the state's coffers, then any federalism issues are necessarily outweighed by the larger concerns of separation of powers.<sup>134</sup>

In addition to federalism concerns, some commentators argue that the

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the Bankruptcy Code. *See id.* These statements are highly controversial, however, because collecting money relating to criminal activity is *not* the same as protecting the public from criminal activity.

<sup>132</sup> *See* Ballam, *supra* note 130, at 21–22. As Professor Ballam notes, by focusing only on federalism concerns, the Supreme Court totally ignored a second constitutional consideration, the Supremacy Clause, which generally takes priority over federalism concerns; *see also* Bodoh & Morgan, *supra* note 121, at n.113 (explaining that once Congress acts under the Bankruptcy Clause, state statutes are simply not permitted to conflict with the resulting federal statute).

<sup>133</sup> *See In re Johnson-Allen*, 871 F.2d 421, 426 (3d Cir. 1989) (holding that restitution obligations arising from the crime of welfare fraud constitute a debt and are thus dischargeable); *Gilliam v. Metropolitan Gov't of Nashville* (*In re Gilliam*), 67 B.R. 83, 85 (Bankr. M.D. Tenn. 1986) (relying on *Brown v. Shiver* (*In re Brown*), 39 B.R. 820, 829 (Bankr. M.D. Tenn. 1984), and stating that a debtor's obligations to pay a criminal fine and court costs constitute debts for bankruptcy purposes and are thus dischargeable); *Brown v. Shriver* (*In re Brown*), 39 B.R. 820, 829 (Bankr. M.D. Tenn. 1984) (relying on *Perez* and holding that a restitution award is dischargeable in bankruptcy); *Redenbaugh v. Gahle* (*In re Redenbaugh*), 37 B.R. 383, 387 (Bankr. C.D. Ill. 1984) (holding that a restitution award is dischargeable); *In re James*, 10 B.R. 2, 4 (Bankr. W.D.N.C. 1980) (holding that the creditor should not be allowed to proceed with prosecution of the debtor for writing a check on insufficient funds unless the debt was determined to be nondischargeable).

<sup>134</sup> Justice Marshall wrote:

While I am wholly in sympathy with the policy interests underlying the Court's opinion, "in our constitutional system the commitment to the separation of powers is too fundamental for us to pre-empt congressional action by judicially decreeing what accords with 'common sense and the public weal.' Our Constitution vests such responsibility in the political branches."

*Kelly v. Robinson*, 479 U.S. 36, 58 (1986) (Marshall, J., dissenting) (quoting *TVA v. Hill*, 437 U.S. 153, 195 (1978)). These concerns about separation of powers and supremacy may explain why the *Kelly* Court relied not only on federalism concerns, but also on section 523, in holding the debt nondischargeable. *See id.* at 49.



preemption doctrine is limited by the constitutional provision from which the relevant federal law flows.<sup>135</sup> In this situation, some argue that we must view the particular conflict between state and federal law through the Bankruptcy Clause, the constitutional enabling provision of the Bankruptcy Code, to ensure that bankruptcy law does not improperly encroach on other aspects of the law.<sup>136</sup> Other scholars argue that this constitutional purpose analysis is unnecessary.<sup>137</sup> According to one Bankruptcy Judge and his former clerk, "[t]he Bankruptcy Clause itself stands for the proposition that once Congress chooses to act under the authority granted to it by the Bankruptcy Clause, this federal bankruptcy law is the supreme law of the land and states have no jurisdiction to enact laws governing the same."<sup>138</sup> This comment, however, may put the rabbit in the hat. After all, what authority is granted to Congress in enacting the Bankruptcy Code? Congress can and occasionally does outstep its bounds,<sup>139</sup> and there are limits to the ways in which the Bankruptcy Code can interfere with legitimate powers of states.<sup>140</sup>

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<sup>135</sup> See Donovan, *supra* note 122, at 122; Michelangelo Scafidi, Comment, *Circumventing State Court Orders of Criminal Restitution: A Bankruptcy Loophole*, 19 J. MARSHALL L. REV. 449, 453 (1986) (pointing out that bankruptcy cannot become a haven for criminals). The first of these two student authors insists that all of bankruptcy law must be viewed in light of its place in jurisprudential history, see Donovan, *supra* note 122, at 122, which he presumably thinks is quite low. As to the second student author, I don't see the recipients of fraudulent welfare funds as the kind of criminals that society is worried about protecting through bankruptcy. See Scafidi, *supra*, at 453.

<sup>136</sup> See Donovan, *supra* note 122, at 122–23. While Mr. Donovan insists that we look to the Bankruptcy Clause to determine bankruptcy's rightful role in the hierarchy of law, he provides no suggestions as to how to do this, nor cites any authorities that shed light on how this would be accomplished.

<sup>137</sup> See Ballam, *supra* note 130, at 24. Professor Ballam argues that whether a state statute violates supremacy principles depends on the purpose of the statute. If the purpose is compensatory, the statute is an invalid violation of supremacy, but if it is deterrent or pecuniary, it is a valid exercise of state power. See Bodoh & Morgan, *supra* note 121, at n.113. Neither of these scholars mentions the need to go back to the Bankruptcy Clause to determine questions of supremacy.

<sup>138</sup> Bodoh & Morgan, *supra* note 121, at n.113.

<sup>139</sup> See *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, 87 (1982) (holding the existing bankruptcy court system unconstitutional because it attempted to vest the judicial power of the United States in non-Article III courts); see also Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 104-317, 110 Stat. 3852 (codified as amended in scattered sections of 28 U.S.C.). The 1984 amendment added 28 U.S.C. § 157(d) (1994), providing that decisions involving conflicts between bankruptcy law and other federal laws enacted under the Commerce Clause should be heard by Article III courts, not bankruptcy courts.

<sup>140</sup> See *supra* note 124 and accompanying text.

The task in determining if preemption occurs is to decide which of two statutes takes precedence when they have conflicting goals. First, this requires a determination that the statutes actually conflict, and if they do, then it requires an identification of the goals of the two competing laws or systems. If there is such a conflict, to the extent permitted by the Bankruptcy Code and the Supremacy Clause, we can attempt to balance these goals.<sup>141</sup> Normally, the federal statute will preempt the state statute. Only truly local issues worthy of special treatment can prevail over conflicting federal law. In the meantime, states will continue to make political decisions, of which the federal government will be entirely unaware.<sup>142</sup> Courts of various genres will then need to decide whether there is a conflict, and if so, whether deference should be given to the state law out of federalism concerns.<sup>143</sup>

### C. *The Police Powers of States*

The Bankruptcy Code defers to federalism concerns by allowing states to

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<sup>141</sup> Areas in which state statutes frequently have been invalidated on the basis of supremacy include: (1) criminal statutes relating to restitutionary debts, for example, those relating to negligently operating a vehicle, *see* *Henry v. Heyison*, 4 B.R. 437, 442 (Bankr. E.D. Pa. 1980), or writing a bad check, *see* *Barnett v. K-Mart (In re Barnett)*, 15 B.R. 504, 512 (Bankr. D. Kan. 1981); (2) spend thrift trusts, *see In re Wimmer*, 121 B.R. 539, 543 (Bankr. C.D. Ill. 1990); (3) exemptions, *see* *Kanter v. Moneymaker*, 505 F.2d 228, 231 (9th Cir. 1974); and (4) environmental statutes, *see* *United Nuclear Corp. v. Cannon*, 553 F. Supp. 1220, 1230 (D.R.I. 1982). While Congress clearly provided for some concurrent laws, such as in the case of exemptions, *see* 11 U.S.C. § 522(b); *Kanter*, 505 F.2d at 231, and also agreed to borrow certain concepts from state law, such as what constitutes property or a security interest; *see In re Gunder*, 8 B.R. 390, 392 (Bankr. S.D. Ohio 1980), this was probably done as much out of convenience as for deference to state law. Whatever the reason, Congress has chosen to defer to states on certain issues but not others.

This results from a hierarchy of laws that has been mandated by the Constitution. Based on a recent Supreme Court case, the hierarchy seems to work as follows. The Fourteenth Amendment rights trump a state's right to sovereign immunity under the Eleventh Amendment. *See* *Robinson v. Department of Transp.*, 394 S.E.2d 590, 591 (Ga. App. 1990). The Eleventh Amendment rights trump the Article I powers, which include those created under the Bankruptcy Clause, the Indian Commerce Clause, and the Patents and Copyrights Clauses. *See* *Seminole Tribe of Fla. v. Florida*, 517 U.S. 44, 72-73 (1996). These Article I powers appear to trump other federal statutes enacted generally by Congress, such as the National Labor Relations Act, but this is not completely clear. Finally, federal statutes enacted generally, as well as under a particular provision of the Constitution, trump state laws on the same subject matter. *See* *Florida Lime & Avocado Growers Inc. v. Paul*, 373 U.S. 132, 142 (1963). In a nutshell, that explains why state statutes dealing with bankruptcy and insolvency may not conflict with the Bankruptcy Code and survive.

<sup>142</sup> *See, e.g., supra* notes 24-26.

<sup>143</sup> *See* *Sward, supra* note 120, at 444-45.

override the bankruptcy system in certain situations in which state interests or policies outweigh federal bankruptcy policies.<sup>144</sup> While bankruptcy generally stops all collection activity against the debtors and their assets through broad automatic stay provisions,<sup>145</sup> the automatic stay does not apply to activities by states exercising their police powers.<sup>146</sup> In other words, states are free to continue exercising their police power, without regard to the bankruptcy filing. The police powers are often defined as those powers necessary to protect the health and safety of citizens.<sup>147</sup> The drafters of the Bankruptcy Code apparently recognized that health and safety concerns override the policies of the Bankruptcy Code and remain within the rightful sphere of the states.<sup>148</sup>

To really balance health and safety concerns against bankruptcy policies, however, one must know what bankruptcy goals these concerns are overriding. The goals of the Bankruptcy Code vary, depending on the type of case involved.<sup>149</sup> For the individual debtor, the primary goal is to discharge all or

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<sup>144</sup> See *Kelly v. Robinson*, 479 U.S. 36, 50 (1986) (citing 11 U.S.C. § 523(a)(7) (1994), which defines nondischargeable debts owed to a governmental unit as a fine or penalty but not as compensation for a pecuniary loss); see also 11 U.S.C. § 362(b)(4) (exempting from the automatic stay any attempt by a state to exercise its valid police power); *id.* § 522 (giving states the right to limit debtors to state exemptions).

<sup>145</sup> See 11 U.S.C. § 362(a).

<sup>146</sup> See *id.* § 362(b)(4).

<sup>147</sup> See, e.g., *Kisler v. Department of Pub. Safety*, 369 U.S. 153, 171 (1962) (stating that state powers protecting life and limb are as pervasive as any state powers and must be protected from federal disempowerment); *Airline Pilots Ass'n v. Continental Airlines (In re Continental Airlines)*, 125 F.3d 120, 133 (3d Cir. 1997) (finding environmental injunction claims to protect health and welfare and thus within states' police powers); *Javens v. City of Hazel Park (In re Javens)*, 107 F.3d 359, 368 (6th Cir. 1997) (finding that demolition statutes protected the public and were thus within the states' police powers).

<sup>148</sup> The legislative history indicates that the police power should be applied narrowly. See 124 CONG. REC. H32350, H32395 (1978, reprinted in 1978 U.S.C.C.A.N. 6436, 6444-45; see also H.R. REP. NO. 95-595, at 343 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6299 (listing specific incidents in which the action or proceeding is not stayed under the automatic stay, including when a governmental unit is suing a debtor to prevent or stop violation of fraud, environmental protection, consumer protection, safety, similar police or regulatory laws, or attempting to fix damages for the violation of such a law).

Courts also have consistently interpreted the police power narrowly. See *TXIA Holdings Corp. v. National Mediation Bd. (In re Continental Airlines Corp.)*, 40 B.R. 299, 304 (Bankr. S.D. Tex. 1984); *Heckler Land Dev. Corp. v. Montgomery (In re Heckler Land Dev. Corp.)*, 15 B.R. 856, 858 (Bankr. E.D. Pa. 1981). Some courts have gone as far as excepting only those actions that are exercises of police powers "urgently" needed to protect the public health and welfare. See *Eisenberg v. Incorporated Village of Mineola (In re IDH Realty, Inc.)*, 16 B.R. 55, 57 (Bankr. E.D.N.Y. 1981); *Schatzman v. Department of Health & Rehabilitation Servs. (In re King Mem'l Hosp., Inc.)*, 4 B.R. 704, 708 (Bankr. S.D. Fla. 1980).

<sup>149</sup> See *infra* notes 150-52 and accompanying text; see also Sward, *supra* note 120,

most debts and walk away from bankruptcy with a fresh start, unhampered by stifling indebtedness and free to become a productive member of society once again.<sup>150</sup> For a corporate debtor who is liquidating its assets, and even one who is reorganizing, a primary goal of the Bankruptcy Code is maximizing the assets available for distribution to creditors.<sup>151</sup> A closely related goal for the reorganizing debtor is reducing economic waste by preserving the debtor's business as a going concern, maximizing creditor returns by paying distributions over time from future earnings, and preserving jobs and other economic relationships.<sup>152</sup>

The question is whether continuing-care statutes protect health and safety and thus fall within the police power exception to the Bankruptcy Code. If they do, the continuing-care statutes can be enforced despite conflicting provisions in the Bankruptcy Code. Recognized exercises of police power include, at the very least, the state's power to regulate the conduct of its citizens for the health and safety of such citizens and for the community as a whole.<sup>153</sup> These concerns are legitimately "local" and thus should remain within the state's control because one would need to "be there" in order to best regulate the activity.<sup>154</sup> Moreover,

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at 408. Professor Sward's article contains an extensive description of the various policies behind the different types of bankruptcy proceedings. *See id.* at 408-14.

<sup>150</sup> *See* Murphy & Robinson Inv. Co. v. Cross (*In re* Cross), 666 F.2d 873, 879 (5th Cir. 1982); Kansas State Bank & Trust Co. v. Vickers (*In re* Vickers), 577 F.2d 683, 686-87 (10th Cir. 1978) (stating that a primary goal of bankruptcy is rehabilitation of the debtor through discharge of indebtedness); Perez v. Campbell, 402 U.S. 637, 648 (1971) (stating that a primary purpose of bankruptcy is to allow individual debtors the opportunity to be free of pre-existing debts); *see also* Nathalie Martin, *Fee Shifting in Bankruptcy: Deterring Frivolous, Fraud-Based Objections to Discharge*, 76 N.C. L. REV. 97, 108-19 (1997).

<sup>151</sup> *See* THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 1-6 (1986) (stating that bankruptcy law's primary concern should be with maximizing the assets available for creditors).

<sup>152</sup> *See, e.g.,* Kathryn R. Heidt, *The Changing Paradigm of Debt*, 72 WASH. U. L.Q. 1055, 1078 (1994) (stating that the goal of bankruptcy is to distribute the effects of failing business); Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 788 (1987) (describing the many benefits to both businesses that are reorganized, as well as persons who do business with a debtor that reorganizes); *see also* Nathalie Martin, *Noneconomic Interests in Bankruptcy: Standing on the Outside Looking In*, 59 OHIO ST. L.J. 429, 436-39 (1998).

<sup>153</sup> *See* RUTH LOCKE ROETTINGER, *THE SUPREME COURT AND STATE POLICE POWER: A STUDY IN FEDERALISM* 10-16 (1957). As Professor Roettinger notes in her doctoral dissertation, the powers of the states are residual powers and consist only of whatever is left over after the federal government exercises its powers "subject to certain constitutional limitations." *Id.*; *see also* Sward, *supra* note 120, at 414.

<sup>154</sup> In other words, some issues simply cannot be regulated from Washington, D.C. because the people enacting such regulations are unfamiliar with local circumstances, physical and cultural topography, or other local concerns. Examples include provisions for the disposal

one would need a vested interest in regulating the activity, which can be absent in massive federal regulatory schemes.<sup>155</sup>

An area in which states have maintained a high degree of regulatory control in bankruptcy is in environmental legislation, which clearly affects the health and safety of citizens.<sup>156</sup> Other heavily regulated areas include zoning,<sup>157</sup> housing,<sup>158</sup>

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of radioactive waste, *see* *New York v. United States*, 505 U.S. 144, 168 (1992), and the regulation of guns in schools, *see* Rachel J. Littman, *Gun-Free Schools: Constitutional Powers, Limitations, and Social Policy Concerns Surrounding Federal Regulation of Firearms in Schools*, 5 SETON HALL CONST. L.J., 723, 769 (1995).

<sup>155</sup> *See* Littman, *supra* note 154, at 769 (suggesting that local regulation was the best way to achieve the national goal of gun-free schools because federalization clogs local autonomy); *see also* Julius Pohlenz, Note, *New York v. United States—Invalidation of the Take Title Provision of the Low-Level Radioactive Waste Policy Amendments Act of 1985 and Its Consequences*, 7 TUL. ENVTL. L.J. 221, 225 (1993) (pointing out that the Court noted that accountability increases if state regulations are encouraged because state officials are more responsive and more directly accountable to local concerns than federal officials).

While many economists and scholars would argue that both state and federal governments regulate far more than they should, some forms of regulation are needed in order to correct market failures that fall through the cracks in capitalism. For an excellent discussion of market failure in the context of environmental regulation, *see* Sward, *supra* note 120, 416–20; *see also* R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 6–7 (1960). This is particularly true when a business or person externalizes costs to people who are outside the chain of production and who have no control over the potentially harmful activity. *See id.* Environmental costs are again a good example. Damaging pollutants can be released into a public water source, for example, and people who depend on that water source will be damaged. The polluter may have no incentive to clean up the damage or stop polluting because the injured people have no market power to stop the activity. The same result would occur if the polluter knew it could discharge the costs of such pollution in bankruptcy. In fact, this is one reason why many environmental claims are not dischargeable in bankruptcy, despite that failing to allow discharge often impedes rehabilitation and creates other societal costs. *See* *Midatlantic Nat'l Bank v. New Jersey Dep't of Env'tl. Protection*, 474 U.S. 494, 505 (1986) (refusing to allow the discharge of environmental clean-up costs resulting from ongoing environmental pollution). We have decided, as a society, that we cannot afford to allow businesses to externalize these environmental costs. The health and safety costs to citizens are simply too high.

<sup>156</sup> *See* Sward, *supra* note 120, at n.67. As Professor Sward points out, “[s]tates also sometimes regulate the environment, because of incentives in the federal legislation.” *See, e.g.,* Clean Water Act, 33 U.S.C. § 1319(a)(1) (1994); Resource Conservation and Recovery Act, 42 U.S.C. § 6926(e) (1994); Clean Air Act, 42 U.S.C. § 7410 (1994). *See generally* Robert L. Glicksman, *Federal Preemption and Private Legal Remedies for Pollution*, 134 U. PA. L. REV. 121 (1985) (discussing whether state common law environmental remedies are preempted by federal environmental statutes); Richard J. Pierce, Jr., *Regulation, Deregulation, Federalism and Administrative Law: Agency Power to Preempt State Regulation*, 46 U. PITT. L. REV. 607 (1985) (arguing that while states regulate many forms of conduct, these regulations often advance state interests at the expense of national interests).

<sup>157</sup> *See* Laurie Reynolds, *Zoning the Church: The Police Power Versus the First Amendment*, 64 B.U. L. REV. 767 (1984); J. Gregory Richards, *Zoning for Direct Social*

employment,<sup>159</sup> hospitals,<sup>160</sup> nursing homes,<sup>161</sup> and financial markets and investment regulations.<sup>162</sup> These are all areas covered by numerous state statutes, which were enacted to protect citizens' health and safety, to preserve the integrity of financial markets, and to maintain a pleasant environment for people to work and play.<sup>163</sup> Some of these goals are probably sufficient to override the policies of the Bankruptcy Code and some probably are not. While regulating CCFs would appear to be within a state's police power, whether a particular provision will be upheld in bankruptcy depends on what the particular provision provides.<sup>164</sup>

While states are permitted to continue enforcing statutes that protect the

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*Control*, 1982 DUKE L.J. 761; Sward, *supra* note 120, at n.74 (citing ROBERT M. ANDERSON, *AMERICAN LAW OF ZONING* (3d ed. 1986)).

<sup>158</sup> See Sward, *supra* note 120, at n.72 (citing various state statutes regulating housing and landlord tenant relations).

<sup>159</sup> See *id.* at n.68 (citing various state statutes regulating employment).

<sup>160</sup> See *id.* at n.71 (citing numerous state statutes regulating hospitals).

<sup>161</sup> See *id.* at n.70 (citing several state statutes regulating nursing homes).

<sup>162</sup> See Floyd, *supra* note 48, at 61-74; see also Sward, *supra* note 120, at n.73 (citing Titus, *Uniform Securities Act* (1985), 19 REV. OF SEC. & COMMODITIES REG. 81 (1986); Braisted, *RUSA Draft: Regulation of Securities by States*, 7 NAT'L L.J. 15 (1985)).

<sup>163</sup> See Sward, *supra* note 120, at 416; see also Sachs v. Ryan (*In re Ryan*), 15 B.R. 514, 519 (Bankr. D. Md. 1981) (discussing various reasons states enact statutes, but confirming that only those designed to protect the health and welfare of citizens are excepted from the automatic stay); Schatzman v. Department of Health & Rehabilitative Servs. (*In re King Mem'l Hosp., Inc.*), 4 B.R. 704, 708 (Bankr. S.D. Fla. 1980) (holding that a state's revocation of a hospital's certificate of need was subject to the automatic stay, absent evidence that protection of health and welfare was an issue). Professor Sward uses many of these examples of state regulation to demonstrate areas that states have found worthy of regulation. While some of the motivations for enacting such statutes may serve valid goals, like maintaining a pleasant work and home environment, these statutes will not necessarily fall within § 362(b)(4), which is defined rather narrowly. See Sward, *supra* note 120, at 414.

<sup>164</sup> In hospital and nursing home cases, courts have refused to enforce certain state certification statutes in bankruptcy because the statute is either related to financial condition or would have a negative pecuniary effect on the debtor. See, e.g., *St. Louis S. Park, II, Inc., v. Missouri Health Facilities Review Comm.* (*In re St. Louis S. Park, II, Inc.*), 111 B.R. 260, 264 (Bankr. W.D. Mo. 1990) (holding that a state cannot remove a nursing home's certificate of need for failure to make required capital expenditures postpetition, even if a state statute authorizes such an act); *Schatzman*, 4 B.R. at 708 (holding that a state cannot remove a hospital's certificate of need for failure to make required capital expenditures); see also *Erlin Manor Nursing Home, Inc. v. Rate Setting Comm'n* (*In re Erlin Manor Nursing Home, Inc.*), 36 B.R. 672, 679 (Bankr. D. Mass. 1984) (holding that the state could not reimburse a Chapter 11 debtor nursing home at a lower rate merely because it had a negative equity, even though a state statute permitted this rate-setting scheme).

public health and safety,<sup>165</sup> no creditor is allowed to collect a prepetition debt during a bankruptcy, *even* a state trying to collect on a judgment.<sup>166</sup> Thus, section 362(b)(4) does not allow a state to continue to collect a civil money judgement, even if the judgement relates directly to police or regulatory power.<sup>167</sup> The police power exception is interpreted very narrowly to allow states to protect health and welfare but not to collect a debt. This is a distinction that makes perfect sense to most bankruptcy judges but must leave some economists scratching their heads.<sup>168</sup>

Assuming the goal of a particular statute is to protect the public, we must answer four questions to determine whether Bankruptcy Code supremacy overrides a state statute. The first question is whether this is a legislative area that is already regulated by the Bankruptcy Code, or an area that comes in direct conflict with provisions of the Bankruptcy Code. The second question is whether this is an area of state or local control. The third question is whether the level of state protection provided is necessary to protect health and welfare, thus rising to the level of police power, as that term is used in section 362(b)(4) of the

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<sup>165</sup> See 11 U.S.C. § 362(b)(4) (1994) (stating that all actions by states to protect health and welfare are excepted from the automatic stay).

<sup>166</sup> See *id.*

<sup>167</sup> See Sward, *supra* note 120, at 422. As the House and Senate reports state:

Paragraph (4) [of section 362(b)] excepts commencement or continuation of actions and proceedings by governmental units to enforce police or regulatory powers. Thus, where a governmental unit is suing a debtor to prevent or stop violation of fraud, environmental protection, consumer protection, safety, or similar police or regulatory laws, or attempting to fix damages for violation of such a law, the action or proceeding is not stayed under the automatic stay. Paragraph (5) makes clear that the exception extends to permit an injunction and enforcement of an injunction, and to permit the entry of a money judgment, but does not extend to permit enforcement of a money judgment. Since the assets of the debtor are in the possession and control of the bankruptcy court, and since they constitute a fund out of which all creditors are entitled to share, enforcement by a governmental unit of a money judgment would give it preferential treatment to the detriment of all other creditors.

*Id.* (citing H.R. REP. NO. 95-595, at 343 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6275-77; S. REP. NO. 95-989, at 52 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5788).

<sup>168</sup> See *id.* While the House and Senate report explanations appear sensible, how much protection can a state provide to citizens without funds from citizens? Thus, unless one assumes that the public can be tapped for resources in an unlimited amount, collecting on a judgment related to public safety is the only way to protect citizens' safety. This is particularly true in the context of environmental problems, but even more problematic in the context of life care contracts, in which the state is not going to make residents whole if they lose their life care investments.

Bankruptcy Code. Finally, one must determine whether the statute constitutes protection from harmful activity or a form of debt collection.

#### *D. Supremacy, the Bankruptcy Code, and State Continuing-Care Statutes*

The regulation of CCFs, in general, seems justified to protect the health and welfare of citizens, for much the same reason that states may regulate hospitals and nursing homes under their police power. The primary goal of all CCF legislation, however, is to protect residents' up front fees and protect against facility insolvency.<sup>169</sup> While states can enact legislation to attempt to prevent insolvency, they probably cannot preclude a CCF from filing for bankruptcy, or control any CCF bankruptcy case that ultimately is filed.<sup>170</sup> States may also be unable to enforce their CCF financial requirements during a bankruptcy case. In enacting state legislation regarding financial health and insolvency, states need to be informed about the effect of federal law on these statutes. Yet some state legislatures were not aware of these concerns when they enacted their CCF

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<sup>169</sup> See N.Y. PUB. HEALTH LAW § 4600 (McKinney 1995 & Supp. 1999). According to the section, the legislative purpose of New York's act is as follows:

The dramatic increase in the numbers of elderly people, especially those seventy-five years of age and older, coupled with the special housing and health care needs of this growing segment of the population, requires development of new and creative approaches to help ensure the care of older people in residential settings of their own choice. If carefully planned and monitored, life care communities have the potential to provide a continuum of care for older people that will provide an attractive residential option for such persons, while meeting their long term care needs for life. To ensure that the financial, consumer, and health care interest of individuals who enroll in such communities will be protected, such communities must be effectively managed and carefully overseen.

The intent of the legislature, therefore, is to allow for the prudent development of life care communities. The legislature further intends to require that the relevant state agencies coordinate the regulation of such communities in order to ensure that there are adequate safeguards for those elderly who become residents and to assist in the orderly development, of such communities. Although lead responsibility for the interagency coordination of the regulation and establishment of such communities is vested in the department of health, the legislature does not intend that such communities become or be perceived as primarily medically-oriented facilities. The legislature intends, instead, that such communities be viewed as an attractive and innovative residential alternative for older New Yorkers who are seeking to maintain, to the extent possible, an independent and active life in a community in which their long-term care needs will be met.

*Id.*

<sup>170</sup> But see *infra* notes 257–83 and accompanying text (discussing the possibility that states can preclude CCFs from filing for bankruptcy).



statutes. Thus, some of the CCF statutes are unenforceable because they violate the Supremacy Clause.

### *1. Definitions, Initial Certification and Funding Requirements, Disclosures to Residents, and Contract Requirements*

Each continuing-care statute or act provides a definition of the entities or contracts covered by the relevant statute,<sup>171</sup> a statement of who is responsible for enforcing the statute,<sup>172</sup> a description of how CCFs get accredited<sup>173</sup> and how

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<sup>171</sup> Most statutes define life care or continuing-care as an arrangement to provide nursing services, medical services, or other health-related services, either for life or for more than one year, in exchange for payment of an entrance fee, a monthly fee, or both, with no change in the monthly fee based on the level of service provided. *See, e.g.*, CAL. HEALTH & SAFETY CODE § 1771 (West 1990 & Supp. 2000); COLO. REV. STAT. § 12-13-101 (1997).

<sup>172</sup> Typically, this responsibility is delegated to the Insurance Commissioner or Director of Department of Insurance, *see, e.g.*, ARIZ. REV. STAT. § 20-1803 (1998); ARK. CODE ANN. § 23-93-104 (Michie 1992); FLA. STAT. ch. 651.015 (Supp. 1999), the Department of Finance, *see* IDAHO CODE § 67-2760 (1995), the Division of Financial Services, *see* COLO. REV. STAT. § 12-13-111 (1997), or the Health Department, *see* LA. REV. STAT. ANN. § 51:2173 (West Supp. 1999).

<sup>173</sup> Certification requirements vary considerably from state to state. Several states, including Colorado, do not address the issue of certification at all. *See* COLO. REV. STAT. § 12-13-104 (1997). Other states have minimal certification requirements. For example, Georgia's statute merely requires that a \$75 application fee accompany the application for a certificate of authority, and Kansas's statute stipulates only that an application for a certificate must be made on a commissioner-approved form and submitted with a \$50 fee. *See* GA. CODE ANN. § 33-45-5 (1996); KAN. STAT. ANN. § 40-2235 (1993). Other states, such as Indiana, Minnesota, and Oregon, require both a small application fee and either disclosure statements or specific financial information about the proposed facility (or sometimes both). *See* IND. CODE § 23-2-4-3 (1992); MINN. STAT. § 80D.03 (1999); OR. REV. STAT. §§ 101.030, 101.040 (1996). In other states, providers applying for certification must pay an application fee and provide a considerable amount of information on the permit application. For example, a partial list of the information that potential Arizona providers must reveal includes: information about all of the community's owners and operators and their affiliations with not for profit or religious organizations; a description of the physical facility; a description of the terms and conditions of the life care contract; certified financial statements; and, if the facility has not been completed, sources and uses of funds, a financial feasibility study, and an actuarial study to determine if the project has sufficient funds. *See* ARIZ. REV. STAT. § 20-1802 (1998). New York is similar in that, in the application, applicants must include, among other things: a feasibility study, including market analysis; an actuarial study; a copy of the proposed contract; and full financial and personal disclosure of directors, board members, and other controlling persons. New York also involves various agency heads in the certification process. For example, the Superintendent of Insurance must approve the actuarial methods and rate methodology to be used; the Commissioner of Social Services must approve aspects pertaining to adult care beds; and the Attorney General must approve as to those aspects relating to a cooperative,

certification is renewed or revoked.<sup>174</sup> Most statutes require initial financial statements<sup>175</sup> and, in a very few states, actuarial studies<sup>176</sup> prior to certification. Most CCF statutes also contain a list of required disclosures to residents and a

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condominium, or other equity arrangement for the independent living unit. *See* N.Y. PUB. HEALTH LAW § 4604 (McKinney 1995).

Still other states do not allow certification until certain minimum financial requirements have been met. In California, for example, before a facility will be certified: a provisional certificate of authority must be issued; the applicant must demonstrate that contracts have been executed on the required percentage of total market test units in the facility and that a satisfactory five-year financial plan of operation has been received by the department; adequate reserves must exist; and all applicable provisions have been met. *See* CAL. HEALTH & SAFETY CODE §§ 1771.2, 1771.4 (West 1990 & Supp. 2000). In Maryland, the provider's application must contain, among other things, verification that agreements have been executed for at least 65% of the independent living units and proof that at least 10% of the total entrance fee for each contracted unit has been collected. *See* MD. ANN. CODE art. 70B, § 11 (1998).

In some states, such as Iowa and Connecticut, construction on new facilities cannot begin until a certain number of living units have been presold and a certain percentage of the entrance fees have been collected. *See* CONN. GEN. STAT. § 17b-526 (1998); IOWA CODE § 523D.5(4) (1998). In Texas, before constructing or acquiring a facility or offering a continuing-care contract to the public, a prospective provider must submit an application for a certificate of authority and pay a \$10,000 filing fee. *See* TEX. HEALTH & SAFETY CODE ANN. §§ 246.021, 246.022 (West 1992).

On the other hand, some states have absolutely no certification requirements. *See* GA. CODE ANN. § 33-45-1 (1996); KAN. STAT. ANN. § 40-2231 (1993); LA. REV. STAT. ANN. § 51:2171 (West Supp. 1999); MASS. GEN. LAWS. ch. 93, § 76 (1998); MINN. STAT. § 80D.02 (1999); MO. REV. STAT. § 420-D:1 (1991); N.M. STAT. ANN. § 24-17-3 (Michie 1996); N.C. GEN. STAT. § 58-64-1 (1996); 40 PA. CONST. STAT. § 3201 (1992); R.I. GEN. LAWS § 23-59-1 (1997).

<sup>174</sup> In many states, such as Arizona, Illinois, and Pennsylvania, a certification or permit is valid until it is revoked. *See* ARIZ. REV. STAT. § 20-1803 (1998); 210 ILL. COMP. STAT. § 1/150-35 (West 1996); 40 PA. CONST. STAT. § 3205 (1992). In other states, such as Florida, Missouri, and South Carolina, annual renewal procedures exist. *See* FLA. STAT. ch. 651.0235 (Supp. 1999); MO. REV. STAT. § 376.935 (1991); S.C. CODE ANN. § 37-11-30 (Law. Co-op. 1999).

<sup>175</sup> Some state statutes specifically require feasibility, market studies, or both. *See* ARIZ. REV. STAT. § 20-1802 (1998); CAL. HEALTH & SAFETY CODE § 1779.4 (West 1990 & Supp. 2000); FLA. STAT. § 651.022 (Supp. 1999); MD. ANN. CODE art. 70B, § 10 (1998); N.Y. PUB. HEALTH LAW § 4604 (McKinney 1995); VT. STAT. ANN. tit. 8, § 8002 (1993); WIS. STAT. § 647.02 (1996).

<sup>176</sup> *See* ARIZ. REV. STAT. § 20-1802 (1998); CONN. GEN. STAT. § 17b-522 (1998); IDAHO CODE § 67-2754 (1995); ME. REV. STAT. ANN. tit. 24-A, § 6203 (West 2000); MD. ANN. CODE art. 70B, § 10 (1998); N.Y. PUB. HEALTH LAW § 4604 (McKinney 1995); S.C. CODE ANN. § 37-11-30 (Law Co-op. Supp. 1999); TEX. HEALTH & SAFETY CODE ANN. § 246.051 (West 1992); VT. STAT. ANN. tit. 8, § 8002 (1993). New Mexico requires actuarial studies only for facilities coming into existence prior to 1997. *See* N.M. STAT. ANN. § 24-17-4 (Michie 1996).

description of the provisions that must be contained in every CCF contract.<sup>177</sup> These initial certification, funding, and disclosure requirements are, by far, the most common provisions in CCF statutes. Virtually all of the statutes contain many of these provisions, and many statutes contain nothing other than these initial requirements.<sup>178</sup>

As a general rule, these initial certification, funding, and disclosure requirements pose no supremacy issues because they are not laws in the "area of bankruptcy."<sup>179</sup> Assuming certification occurs prior to bankruptcy,<sup>180</sup> the initial requirements do not have the purpose or effect of interfering with bankruptcy law or policy and pose no obstacles to the fulfillment of the goals of the Bankruptcy Code.<sup>181</sup> Thus, it is unnecessary to address the question of whether they constitute a valid exercise of state police power.<sup>182</sup>

## 2. Ongoing Financial Obligations and Regulations

In addition to the preliminary financial requirements discussed above, some states also require a variety of ongoing financial disclosures and obligations.<sup>183</sup>

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<sup>177</sup> See, e.g., CONN. GEN. STAT. §§ 17b-522, 17b-532 (1998); FLA. STAT. ch. 651.091 (Supp. 1999); GA. CODE ANN. § 33-45-7 (1996); IDAHO CODE §§ 67-2754, 67-2755 (1995); IOWA CODE §§ 523D.3, 523D.6 (1998); KAN. STAT. ANN. § 40-2233 (1993); N.H. REV. STAT. ANN. § 420-D:12 (1998); N.M. STAT. ANN. §§ 24-17-4, 24-17-5 (Michie 1996); N.C. GEN. STAT. § 58-64-28 (1996); S.C. CODE ANN. §§ 37-11-35, 37-11-60 (Law. Co-op. Supp. 1999).

<sup>178</sup> See, e.g., DEL. CODE ANN. tit. 18, § 4605 (1999); GA. CODE ANN. § 33-45-7 (1996); IDAHO CODE § 67-2755 (1995); IOWA CODE § 523D.6 (1998); KAN. STAT. ANN. § 40-2233 (1993); LA. REV. STAT. ANN. § 51:2178 (West Supp. 1999); MASS. GEN. LAWS ch. 93, § 76 (1998); N.M. STAT. ANN. § 24-17-1 (Michie 1996); OHIO REV. CODE ANN. § 173.13 (Anderson 1994); R.I. GEN. LAWS § 23-59-3 (1997); S.C. CODE ANN. §§ 37-11-35 (Law. Co-op. Supp. 1999); TENN. CODE ANN. § 4-3-1305 (1991); VA. CODE ANN. § 38.2-4903 (Michie 1999); WIS. STAT. § 647.05 (1996). Each of these statutes has very limited protections for residents in the beginning of the contract period, but almost no additional protections for residents to guard against insolvency. See *infra* notes 183-99 and accompanying text.

<sup>179</sup> See *supra* notes 122 and accompanying text.

<sup>180</sup> If not, these provisions probably will not be enforced during a bankruptcy case. See *infra* notes 194-99 and accompanying text.

<sup>181</sup> See *id.*

<sup>182</sup> Most initial certification requirements are quite helpful, especially those relating to financial condition, market analyses, and actuarial studies. Extensive disclosures, on the other hand, appear less helpful, as I doubt they are actually read.

<sup>183</sup> See *infra* notes 184-93 and accompanying text. Naturally, states should continue to have ongoing statutory financial obligations to residents. After all, enormous sums of money are collected during the initial certification period, and this money dissipates over the life of a CCF. In reality, however, many of the ongoing financial obligations are too minimal to protect residents against loss.

For example, many states that regulate CCFs require that CCFs escrow all or a portion of a resident's entrance fee prior to the resident's occupancy,<sup>184</sup> and provide that entrance fees are refundable for a period of seven days after the contract is signed.<sup>185</sup> Far more important than these minimal short-term entry requirements are the financial obligations relating to the long-term viability of the facility. These provisions are less common and typically require ongoing actuarial studies, surety and fidelity bonds to protect resident investments, and

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While most states require annual reports from CCFs, the requirements regarding the contents of these reports vary from state to state. Some states' statutes are limited in their description of the reports' requirements. For example, Arkansas's statute simply stipulates that the annual disclosure statement include all of the information in the initial disclosure statement and a financial statement audited and certified by a CPA, while Louisiana's statute merely requires that a provider must file a disclosure statement annually within four months after the end of its fiscal year. In addition, it must list any changes in the initial disclosure statement. *See* ARK. CODE ANN. § 23-93-106 (Michie 1992); LA. REV. STAT. ANN. § 51:2176 (West Supp. 1999). However, other states require much more information. Connecticut facilities must include in their reports: financial and actuarial information; the average age of residents for the next five years; health care utilization; admission rates; and occupancy rates. *See* CONN. GEN. STAT. § 17b-527 (1998). Similarly, Maryland CCFs must include information on finances, the projection of life expectancy for residents who will require nursing home care, information on advertising campaigns, and every three years, actuarial studies. *See* MD. ANN. CODE art. 70B, § 11 (1998).

<sup>184</sup> The escrow provisions generally require that the CCF escrow a resident's entrance fee until the resident begins occupying the premises. *See, e.g.,* ARIZ. REV. STAT. § 20-1804 (1998); ARK. CODE ANN. § 23-93-112 (Michie 1992); IND. CODE § 23-2-4-10 (1992); MINN. STAT. § 80D.20 (1999); VT. STAT. ANN. tit. 8, § 8008 (1993). A few states use the word "escrow" to describe a reserve fund, which protects residents from loss *after* occupancy. *See, e.g.,* FLA. STAT. ch. 651.035 (Supp. 1999); 40 PA. CONST. STAT. ANN. § 3210 (1992); TEX. HEALTH & SAFETY CODE ANN. § 246.077 (West 1992). Pennsylvania also has a regular escrow requirement, *see* 40 PA. CONST. STAT. ANN. § 3210 (1992).

<sup>185</sup> *See* ARIZ. REV. STAT. § 20-1802 (1998); ARK. CODE ANN. § 23-93-109 (Michie 1992); COLO. REV. STAT. § 12-13-105 (1991); GA. CODE ANN. § 33-45-7 (1996); IDAHO CODE § 67-2755 (1995); R.I. GEN. LAWS § 23-59-6 (1997); TEX. HEALTH & SAFETY CODE ANN. § 246.056 (West 1992); VA. CODE ANN. § 38.2-4905 (Michie 1999). In some states, residents can get refunds or a longer period of time. *See* MASS. GEN. LAWS ch. 93, § 76 (1998); MD. ANN. CODE art. 70B, § 14 (Supp. 1999) (for which refunds must be made available for the entire pre-occupancy period). Other states permit refunds even after occupancy, for thirty days; *see, e.g.,* CONN. GEN. STAT. § 17b-523 (1998); IOWA CODE § 523.D6 (1998); LA. REV. STAT. ANN. § 51:2178 (West Supp. 1999); N.J. STAT. ANN. § 52:27D-344 (West Supp. 1999); N.C. GEN. STAT. § 58-64-25 (1996); VT. STAT. ANN. tit. 8, § 8006 (1993); WIS. STAT. § 647.058 (1996); some states permit refunds for one year, *see* ME. REV. STAT. ANN. tit. 24-A, § 6212 (West 2000); some states permit refunds for an unlimited time up to the amount of the CCF's accrued costs for that patient, *see* FLA. STAT. ch. 651.055 (Supp. 1999).

most importantly, reserves of entrance fees.<sup>186</sup> These provisions are designed to protect residents from insolvency.<sup>187</sup>

Only four states require CCFs to procure surety or fidelity bonds to protect residents against loss and even then, typically in undesignated amounts.<sup>188</sup> Only eight states require CCFs to procure ongoing actuarial studies.<sup>189</sup> Finally, while reserving entrance fees for future nursing care costs is virtually the *only* way to preserve ongoing financial viability in this industry, only fifteen states require reserves, and most of these requirements are far from stringent.<sup>190</sup>

The most common reserve provisions require that the facility maintain, on a current basis, an amount equal to the principal and interest payments due during the next twelve months for any first mortgage or other long-term financing of the

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<sup>186</sup> See *infra* notes 189–93 and accompanying text.

<sup>187</sup> See *id.*

<sup>188</sup> See CAL. HEALTH & SAFETY CODE § 1774 (West 1990 & Supp. 2000) (requiring bonds for employees and agents with access to substantial amounts of funds); GA. CODE ANN. § 33-45-4 (1996) (requiring a compliance bond of not less than \$10,000); IDAHO CODE § 67-2756 (1995) (requiring a surety bond, reserves, or a letter of credit or other financial arrangement in undesignated amount, to establish financial security); S.C. CODE ANN. §§ 37-11-40 (Law. Co-op. Supp. 1999) (same). Michigan's statute proscribes that the state *may* require a bond if necessary to protect residents. See MICH. COMP. LAWS § 544.816 (West 1994).

<sup>189</sup> See, e.g., ARIZ. REV. STAT. § 20-1807 (1998) (requiring an actuarial study at least every three years); CONN. GEN. STAT. § 17b-527 (1998) (requiring annual studies); IDAHO CODE § 67-2754 (1995) (requiring studies every five years); ME. REV. STAT. ANN. tit. 24-A, § 6223 (West 1989 & Supp. 1999) (requiring annual studies); MD. ANN. CODE art. 70B, § 11 (1998) (requiring studies every three years); MINN. STAT. § 80D.025 (1998) (requiring studies annually, to establish reserves); N.Y. PUB. HEALTH LAW § 4604 (McKinney Supp. 1999) (requiring studies annually); TEX. HEALTH & SAFETY CODE ANN. § 246.114 (West 1992 & Supp. 2000) (requiring studies every five years). South Carolina requires a summary of an actuarial report to be updated every two years. See S.C. CODE ANN. § 37-11-30 (Law Co-op. Supp. 1999). New Mexico's statute requires that providers produce an annual disclosure statement which must include—for those communities that charge an entrance fee that were not in operation on the effective date of the Continuing-care Act—an actuarial analysis of the community performed by an actuary experienced in analyzing continuing-care communities. See N.M. STAT. ANN. § 24-17-4 (Michie 1996).

<sup>190</sup> See ARIZ. REV. STAT. § 20-1804 (1998); ARK. CODE ANN. § 23-93-111 (Michie 1992); CAL. HEALTH & SAFETY CODE § 1775 (West 1990 & Supp. 2000); COLO. REV. STAT. § 12-13-107 (1991); FLA. STAT. ch. 651.035 (Supp. 1999); ME. REV. STAT. ANN. tit. 24-A, § 6215 (West 2000); MD. ANN. CODE, art. 70B, § 11 (1998); MINN. STAT. § 80D.06 (1998); MO. REV. STAT. § 376.945 (1991); N.H. REV. STAT. ANN. § 420-D:8 (1998); N.J. STAT. ANN. § 52:27D-339 (West Supp. 1999); OR. REV. STAT. § 101.060 (1996); 40 PA. CONST. STAT. ANN. § 3201 (West 1992); TEX. HEALTH & SAFETY CODE ANN. § 246.077 (West 1992); VT. STAT. ANN. tit. 8, § 8009 (1993).

facility.<sup>191</sup> These statutes require that the reserves be sufficient to cover long-term debt for one year, but do not require reserves for ongoing operating expenses for any period. Some states do require reserves for various minimal operating expenses. For example, Florida requires that a facility set aside operating reserves in an amount equal to thirty percent of the total operating expenses projected in the facility's feasibility study for the first twelve months of operation.<sup>192</sup> Of course, these operating expenses must only be reserved during the start-up phase, and most financial failure occurs after this period. Even states that require reserves for ongoing operating expenses, beyond the start-up phase, only require them for two or three months.<sup>193</sup>

These ongoing financial requirements are underutilized in the state statutes.

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<sup>191</sup> See, e.g., ARIZ. REV. STAT. § 20-1806 (1998); MINN. STAT. § 80D.06 (1998); TEX. HEALTH & SAFETY CODE ANN. § 246.077 (West 1992).

<sup>192</sup> See FLA. STAT. ch. 651.035 (Supp. 1999).

<sup>193</sup> New Hampshire requires facilities to set aside a portion of two months' operating expenses relating to life care residents. See N.H. REV. STAT. ANN. § 420-D:8 (1998). Oregon requires facilities to set aside a portion of operating expenses for three months. See OR. REV. STAT. § 101.060 (1999). Still, having secured status in the first place is better than nothing. If nothing else, holding a statutory lien provides some negotiating power, unless of course, the statutory lien is only effective upon bankruptcy or insolvency. Other states have developed alternative reserve methods. Pennsylvania requires each facility to hold twelve months' worth of debt service payments in reserve, or 10% of the projected annual operating expenses of the facility, whichever is greater. See 40 PA. CONST. STAT. § 3209 (1992). Vermont and New Jersey's statutes are similar. Vermont requires facilities to set aside the equivalent of a year's principal and interest payments or 15% of annual operating expenses, whichever is greater. See VT. STAT. ANN. tit. 8, § 8009 (1993). New Jersey requires the same yearly equivalent or 15% of the projected annual operating expenses of the facility, exclusive of depreciation. See N.J. REV. STAT. ANN. § 52:27D-339 (West Supp. 1999). Colorado's statute requires that each facility maintain reserves equivalent to the next eighteen months' principal and interest on those debt obligations that are collateralized by the provider's facility and require a balloon payment, *plus* an amount equal to the next twelve months' principal and interest for all other debt obligations that are collateralized by the provider's facility, *plus* an amount not less than 20% of the facility's operating expenses for the immediately preceding year. See COLO. REV. STAT. § 12-13-107 (1991). Other states base the reserve requirements on the actuarially determined annual refund amount, see ARK. CODE ANN. § 23-93-111 (Michie 1992), which is based on the amount residents have a right to receive, in cash, if they die or leave the facility. Again, this figure is not based on what is necessary for the long-term survival of the facility and constitutes a far lower number than what would support the operations of the facility over the long-term. The most effective statute by far, and the only one that requires reserves in amounts sufficient to support the facility over the long term, is Maine's statute, which requires that each provider's reserves equal the excess of the present value of the future benefits promised under the continuing-care agreement over the present value of the future revenues and any other available resources, based on conservative actuarial assumptions. See ME. REV. STAT. ANN. tit. 24-A, § 6215 (West 2000).

The surety and fidelity bond requirements, the requirements for ongoing actuarial studies, and the reserve requirements, all protect residents from insolvency. If more frequently used, the surety bonds would help pay residents for future care to be received elsewhere if a facility liquidates. The actuarial studies would keep the facility informed of deteriorating financial conditions so they could attempt to reverse them. The reserve requirements, more than any other, would help avoid insolvency entirely by forcing facilities to prepare for a strong financial future. These goals are all extremely important, and this subject matter is clearly worthy of more state legislation.

While these provisions do not pose obvious supremacy problems, this is not to say they will always be upheld during the course of a bankruptcy. They may conflict with certain provisions of the Bankruptcy Code, but are unquestionably a valid exercise of police power.<sup>194</sup> Reserve and surety bond requirements are unlikely to be upheld as valid exercises of state police power, however, because they are likely to be seen as debt collection provisions rather than provisions directed primarily at protecting health and welfare.<sup>195</sup> In analogous cases in the hospital and nursing home contexts, states have been precluded from enforcing state statutes that required withdrawal of certification from a facility, postpetition, as a result of failing financial conditions.<sup>196</sup> Courts have seen such statutory provisions as unrelated to health and welfare. Another reason that courts have refused to allow states to enforce such statutes is that doing so would arguably affect a pecuniary interest in the debtor's property.<sup>197</sup>

The distinction between protecting health and welfare on the one hand, and protecting pecuniary interests on the other, makes very little sense in this context.<sup>198</sup> It is impossible for states to protect residents in this context if they cannot enforce the financial obligations contained in these statutes. There is nowhere else for residents to go if they lose their money, and unlike insurance

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<sup>194</sup> See *supra* notes 144–64 and accompanying text.

<sup>195</sup> See *supra* notes 163–68 and accompanying text. As for the ongoing actuarial studies, I doubt these would be enforceable if getting the study would be too expensive for the debtor. Public companies are often permitted to cease making S.E.C. disclosures during a Chapter 11, due to the expense of complying with S.E.C. requirements during the rehabilitation period.

<sup>196</sup> See *St. Louis S. Park, II, Inc. v. Missouri Health Facilities Review Comm. (In re St. Louis S. Park, II, Inc.)*, 111 B.R. 260 (Bankr. W.D. Mo. 1990) (denying a state the right to revoke a nursing home certification of need based on the home's financial condition, as a violation of the automatic stay); *Erlin Manor Nursing Home, Inc. v. Rate Setting Comm'n (In re Erlin Manor Nursing Home, Inc.)*, 36 B.R. 672, 678 (Bankr. D. Mass 1984) (refusing to allow revocation of hospital certification solely because of hospital's poor financial condition).

<sup>197</sup> See *St. Louis Park*, 111 B.R. at 263 (stating that the home needed its certification of need to continue its business); *Erlin Manor*, 36 B.R. at 678 (stating that lower reimbursements would take money away from the estate and its creditors).

<sup>198</sup> See *supra* note 168 and accompanying text.

insolvencies, there is no general state fund from which to reimburse residents.<sup>199</sup> Fortunately, these provisions are extremely valuable, and fully enforceable, prior to and after bankruptcy and are thus well worth enacting.

### 3. *Statutory Liens*

The best way for states to protect residents from the harm that occurs once a bankruptcy has been filed is to create security interests in favor of the residents. To be effective, these security interests must be recognized in bankruptcy, and should also be higher in priority than general unsecured claims as well as many secured claims. At least nine states have tried to achieve secured status on behalf of residents by providing CCF residents with a statutory lien in their facility's assets. Some of these statutes are effective, while others are ineffective.<sup>200</sup> The two primary things states can do to make their statutory liens enforceable in bankruptcy is to make them effective upon occupancy, not insolvency, and to make them as easy as possible to perfect.<sup>201</sup>

The holder of a statutory lien obtains a secured interest in specific goods and thus obtains the status of a secured creditor even though the holder did not bargain for collateral.<sup>202</sup> While statutory liens are created by state political processes and interfere with the Bankruptcy Code's established priority system, they are as valid in bankruptcy as consensual liens and judgment liens.<sup>203</sup> Because state legislatures enact these liens, they naturally vary from state to

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<sup>199</sup> One state, Indiana, does have a fund that purportedly pays the claims of residents whose CCF becomes insolvent. See IND. CODE § 23-2-4-13 (1992). The state collects \$100 from each resident who signs a CCF contract, to be used to reimburse residents whose facilities have ceased operation. See *id.* This seems like an excellent idea, although the amount collected in Indiana appears to be too low to actually compensate for losses of any substantial size.

<sup>200</sup> See *infra* notes 210-19 and accompanying text.

<sup>201</sup> The reason for this last suggestion is obvious. To err is human and the fewer prospects for botching perfection, the more likely that residents will receive the protections intended by the legislature.

<sup>202</sup> See Margaret Rosso Grossman & Keith G. Meyer, *Agricultural Credit Institutions, Operations and Guarantees in the United States*, 46 AM. J. COMP. L. 275, 315 (1998).

<sup>203</sup> See 11 U.S.C. § 506 (1994). Section 506 grants secured status to any creditor with a lien on property in which the debtor has an interest. This status is not limited to voluntary or consensual security interest granted under Article 9 of the U.C.C. See U.C.C. § 9-101 to 9-504 (1994) (revised 1977); *In re Brentwood Outpatients, Ltd.*, 43 F.3d 256, 260 (6th Cir. 1994) (holding that only the consensual lienholders, holders of judicial liens that are oversecured, are entitled to interest, penalties, fees, and costs that accrue prepetition); see also *United States v. Ron Pair Indus.*, 489 U.S. 235, 243 (1989) (holding that statutory or judicial tax liens that are oversecured are entitled to recover costs and fees under section 506); 11 U.S.C. § 547(c)(6) (excepting liens that are valid under section 545 from preference statutory liens).



state.<sup>204</sup> These liens generally are provided to people who have improved or repaired goods on credit or who otherwise have given value to the debtor, and who also have preserved or enhanced the value of the property subject to the lien.<sup>205</sup>

Statutory liens may be invalidated in bankruptcy, however, in one of two ways. Some are invalid because state law requires perfection and the liens are unperfected under relevant state law. Others are avoidable because they do not become effective until the debtor becomes insolvent or files for bankruptcy; in a sense, these liens are thus not perfected soon enough. The unperfected statutory liens are avoidable under section 545(2),<sup>206</sup> because they are invalid against a judicial lien holder or a bona fide purchaser.<sup>207</sup> Liens that are perfected upon bankruptcy are invalidated under section 545(1), which provides that statutory liens that come into existence only upon bankruptcy or insolvency are voidable.<sup>208</sup> The Bankruptcy Code invalidates these legislatively created economic priorities to ensure that the priority system set out in the Bankruptcy

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<sup>204</sup> Grossman & Meyer, *supra* note 202, at 299 (discussing how agricultural liens enacted by states are not uniform from state to state). Statutory liens are also very different from consensual and judgment liens because they are provided to everyone in the population in certain categories, regardless of the contractual or tort-related obligations of a particular citizen. They have been provided to warehousemen, garagemen, agricultural creditors, and most commonly, to mechanics and subcontractors. Virginia is one state in which these individuals have been provided statutory liens. See VA. CODE ANN. §§ 43-29, 43-33 (Michie 1999).

<sup>205</sup> See Grossman & Meyer, *supra* note 202, at 315. Given that the residents have prepaid for services, but unlike mechanics or subcontractors, have provided no specific benefit related to any particular property, fitting these liens into the traditional statutory lien model is somewhat forced. See *id.*

<sup>206</sup> 11 U.S.C. § 545(2).

<sup>207</sup> Liens that are not perfected under state law, that can be avoided under the trustee's strong-arm provisions, are also avoidable in bankruptcy. Examples of liens that have been defeated under the strong-arm powers include unperfected landlord liens for unpaid rent, see, e.g., MINN. STAT. § 514.960 (1999); *In re Waldo*, 70 B.R. 16 (Bankr. N.D. Iowa 1986), and agricultural liens, see, e.g., CAL. CIV. CODE §§ 3051-52, 3061 (West 1993). These statutory liens create no recognizable property rights and are void as improper attempts to circumvent the priority system set forth in section 507 of the Bankruptcy Code. See 11 U.S.C. § 507.

<sup>208</sup> See Buckmaster de Wolf, Comment, *Strange Things Are Afoot at the Circle K: Agency Action Against Leased Sites in Environmental Bankruptcy*, 21 B.C. ENVTL. AFF. L. REV. 145, 169 (1993); see also Lampport, *supra* note 112, at 611. Mr. Lampport notes that state statutory liens that exist only upon insolvency or bankruptcy are disguised state priorities, which are not permitted to take priority over the Bankruptcy Code priority system. See *id.*; see also Margaret Russo Grossman, *Troubled Times: The Farm Debtor Under the Amended Bankruptcy Code*, 38 OKLA. L. REV. 579, 609 (1985).

Code, rather than those enacted individually by particular states, is the sole priority system utilized in the bankruptcy arena.<sup>209</sup>

State statutes that impose or permit the imposition of statutory liens in favor of residents against the assets of CCFs<sup>210</sup> can be extremely beneficial to residents, assuming they survive bankruptcy. Statutes such as those enacted in Arkansas, California, and North Carolina, however, purport to impose a lien only

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<sup>209</sup> See 11 U.S.C. § 507 (1994) (setting out the Bankruptcy Code's priority system). States are not permitted to interfere with this system, although statutory liens that are enforceable as of bankruptcy are still valid in bankruptcy, presumably because secured status is determined by reference to state law. This is an area of law that remains confused. While one court plainly proclaimed that a precode bankruptcy amendment eliminated all state priorities except a claim for rent in landlords, *see Elliott v. Bumb*, 356 F.2d 749, 755 (9th Cir. 1966), it is clear that statutory liens remain enforceable in bankruptcy, *see Selby v. Ford Motor Co.*, 590 F.2d 641-42, 645 (6th Cir. 1979) (holding that a statutory lien is not effective against the claims of a bankruptcy trustee unless it is effected prior to the filing of a bankruptcy); *see also* W. Mark Rasmussen, Comment, *Grain Elevator Bankruptcy—Has Illinois Successfully Provided Security to Farmers?*, 1983 S. ILL. U. L.J. 337, 345. In this comment, Mr. Rasmussen discusses the interesting question of whether grain elevator liens must be levied upon and also whether the liens actually provide any protection to farmers when there is a federal bankruptcy. *Id.*; *see also* Grossman & Meyer, *supra* note 202, at 324; Keith G. Meyer, *Should the Unique Treatment of Agricultural Liens Continue?*, 24 IND. L. REV. 1315, 1326 (1991) (discussing how and why section 545 invalidates state statutory liens).

Another category of statutory lien that is voidable under section 545 consists of those that are not perfected or enforceable at the time a bankruptcy is filed against a judicial lien holder or a bona fide purchaser. *See* 11 U.S.C. § 545(2). The debtor or trustee can avoid such a lien under power that is analogous to a trustee's strong-arm power to avoid consensual liens in certain situations. *See In re J.R. Nieves & Co.*, 446 F.2d 188, 193-94 (1st Cir. 1971); Grossman, *supra* note 208, at 608. Statutory liens that are not valid against both judicial lien creditors and bona fide purchasers are simply disguised priorities, which create eleventh-hour preferences in favor of certain creditors at the expense of general unsecured creditors. *See* John C. Anderson & John A. Hollister, *The Effect of Bankruptcy of Liquidations on Louisiana Security Devices*, 31 LOY. L. REV. 1, 48 (1985).

<sup>210</sup> *See, e.g.*, ARIZ. REV. STAT. § 20-1805 (1998); ARK. CODE ANN. § 23-93-113 (Michie 1992); MINN. STAT. § 80D.08 (1999); N.H. REV. STAT. ANN. § 420-D:9 (1998); N.J. STAT. ANN. § 52:27D-341 (West Supp. 1999); 40 PA. CONST. STAT. § 3211 (West 1992); TEX. HEALTH & SAFETY CODE ANN. § 246.111 (West Supp. 2000). Florida and North Carolina have enacted provisions providing that residents shall have preferred claims in any liquidation, but do not use the word "lien." *See* FLA. STAT. ch. 651.071 (Supp. 1999); N.C. GEN. STAT. § 58-64-60 (1996). New Hampshire's rehabilitation provisions provide that, in any liquidation of a facility, the proceeds of liquidation shall be used to provide for residents. *See* N.H. REV. STAT. ANN. § 3211 (1998). This language essentially provides for the same preferred status, but cannot possibly be reconciled with the Bankruptcy Code's priority system or the respective claims of other creditors. If a state wants to create a lien that is valid in bankruptcy, the safest course is to use the word "lien."

upon bankruptcy, insolvency, or receivership, in clear violation of section 545.<sup>211</sup> Arkansas' statute for example, provides that "[i]n the event of the bankruptcy . . . of [a] provider resulting from the financial difficulties of the provider, the residents of the facility shall have a statutory lien on the real and personal property of the facility."<sup>212</sup> These statutes—which provide that the lien comes into being upon bankruptcy, insolvency, or receivership—create no benefits whatsoever for residents and are dangerously misleading.<sup>213</sup> As long as CCFs remain eligible for bankruptcy, these statutes constitute a waste of legislative energy.<sup>214</sup> In fact, they are more harmful than helpful because they create an incentive to file for bankruptcy in order to invalidate the lien under section 545. These liens also create a false sense of security.

Other attempts to create valid liens fail because they are too vague or do not use language that creates an interest in property. Florida's and New Hampshire's statutes create a "preferred claim" in favor of residents in any liquidation,<sup>215</sup> but

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<sup>211</sup> See ARK. CODE ANN. § 23-93-113 (Michie 1992); CAL. HEALTH & SAFETY CODE § 1772 (West 1990); N.C. GEN. STAT. § 58-64-60 (1996).

<sup>212</sup> ARK. CODE ANN. § 23-93-113 (Michie 1992).

<sup>213</sup> See 11 U.S.C. § 545. Section 545 provides that:

The trustee may avoid the fixing of a statutory lien on property of the debtor to the extent that such lien—

(1) first becomes effective against the debtor—

- (A) when a case under this title concerning the debtor is commenced;
- (B) when an insolvency proceeding other than under this title concerning the debtor is commenced;
- (C) when a custodian is appointed or authorized to take or takes possession;
- (D) when the debtor becomes insolvent;
- (E) when the debtor's financial condition fails to meet a specified standard;
- or
- (F) at the time of an execution against property of the debtor levied at the instance of an entity other than the holder of such statutory lien;

(2) is not perfected or enforceable at the time of the commencement of the case against a bona fide purchaser that purchases such property at the time of the commencement of the case, whether or not such a purchaser exists;

(3) is for rent; or

(4) is a lien of distress for rent.

*Id.*

<sup>214</sup> Perhaps there is some deterrent effect created even by the ineffective statutes, but I question if this effect is outweighed by the effort spent enacting these statutes and the harms caused by them.

<sup>215</sup> See FLA. STAT. ch. 651.071 (Supp. 1999); N.C. GEN. STAT. § 58-64-60 (1999).

these preferred claims are not interests in any particular property.<sup>216</sup> These preferred claims are similar to priority claims in bankruptcy, which are satisfied from all assets remaining after secured claims (including valid statutory liens) have been paid in full.<sup>217</sup> Similarly, New Hampshire's statute provides that in the event of liquidation, the proceeds of the facility shall be used to provide for residents.<sup>218</sup> The "proceeds" referred to are the proceeds left after satisfying secured claims.<sup>219</sup> These provisions, purporting to create state priorities, are preempted by the Bankruptcy Code's priority system and are thus unenforceable.<sup>220</sup> Needless to say, these statutes do not protect residents as well as valid statutory liens.

Other states have enacted effective statutory liens. For example, in Minnesota, a statutory lien in favor of residents is imposed automatically as soon as the first resident occupies the facility.<sup>221</sup> Similar statutes have been enacted in Arizona, Colorado, and Texas.<sup>222</sup> The Texas statute provides that a lien exists on the real and personal property of the provider or facility to secure the obligations of the provider pursuant to existing and future contracts for continuing care<sup>223</sup> when the facility is first occupied by a resident.

These statutory liens do not become effective only upon bankruptcy, insolvency, or other deteriorating financial conditions; rather they are imposed regardless of insolvency.<sup>224</sup> As a result, they appear to be impervious to section

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<sup>216</sup> See *United States v. Saidman*, 231 F.2d 503, 507 (D.C. Cir. 1956) (stating that to be effective, a lien must indicate the specific property to which the lien attaches); see also *In re Lobel Enters.*, 126 F. Supp. 792, 793 (D.D.C. 1954) (stating that specific language granting a lien on specific property takes precedent before language creating a "preferred" or "first-satisfied" claim). In both the latter instances, the claims are to be "preferred" or "first satisfied" from general assets of the estate, once all secured claims are satisfied.

<sup>217</sup> See *Lobel*, 126 F. Supp. at 793.

<sup>218</sup> N.H. REV. STAT. ANN. § 420-D:16 (1998).

<sup>219</sup> See *Lobel*, 126 F. Supp. at 793.

<sup>220</sup> See *McCarroll v. Jean (In re R.W. May Co.)*, 119 F.2d 71, 74 (8th Cir. 1941) (holding that in the context of a tax claim, only priorities recognized in the Bankruptcy Act are given priority treatment in bankruptcy); *In re Elliott Wholesale Grocery Co.*, 98 F. Supp. 1017, 1018 (S.D. Cal. 1951) (stating that severance benefits recognized in the Bankruptcy Act are given priority treatment); see also *In re Unit Lock Co.*, 49 F.2d 313, 316 (N.D. Okla. 1931) (stating that bankruptcy priority takes over state priorities).

<sup>221</sup> See MINN. STAT. § 80D.08 (1998).

<sup>222</sup> See ARIZ. REV. STAT. § 20-1805 (1998) (providing that a director must record a lien as a condition to granting a permit); TEX. HEALTH & SAFETY CODE ANN. § 246.111 (West Supp. 2000) (providing that a lien effective for ten years attaches upon first occupancy by a resident).

<sup>223</sup> See TEX. HEALTH & SAFETY CODE ANN. § 246.111 (West Supp. 2000).

<sup>224</sup> See 11 U.S.C. § 545(1) (1994).

545(1) and valid in bankruptcy.<sup>225</sup> Thus, statutes like those enacted by Minnesota, Arizona, Colorado, and Texas are enforceable in bankruptcy and protect the interests of residents, assuming that there are assets over and above secured claims available to satisfy such claims.

To make sure that statutory liens are perfected under state law, and are thus impervious to section 545(2) as well, three other issues must be considered: (1) whether the liens are automatically effective or must be recorded or filed; (2) what priority the liens should have; and (3) whether the liens can be subordinated to other voluntary liens if the facility requires additional financing. Ideally, the liens should be effective automatically upon certification, without the need to file anything.<sup>226</sup> However, such a lien may be effective only against personal property, and thus the best statute would also require that the commissioner record any lien in favor of residents against real property.<sup>227</sup> The priority of the

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<sup>225</sup> *Id.*

<sup>226</sup> This may be impossible under some state laws, particularly if real estate is involved. Most states permit liens on personal property to be effective automatically, by specifically providing for automatic perfection in the statute creating the lien. Thus, secret liens on personal property seem to be enforceable, even in bankruptcy, assuming the lien is perfected validly under the applicable state law. *See Merchants Grain, Inc. v. Adkins (In re Merchants Grain, Inc.)*, 184 B.R. 52, 58 (S.D. Ind. 1995). *Compare In re Fennelly*, 212 B.R. 61 (D.N.J. 1997) with *Graffen v. City of Philadelphia*, 984 F.2d 91, 94 (3d Cir. 1992). In both *Fennelly* and *Graffen*, the liens in issue had to be perfected by recording or filing under the relevant statute creating the lien. Because the creditor failed to properly perfect, the liens were voidable. A lien governed by automatic statutory perfection without any need for filing, would appear to be perfected upon the event triggering the lien. *See, e.g., MINN. STAT. § 80D.08* (1999). As for liens on real estate, it seems necessary to file *something* with the relevant recorder of deeds in order to make the lien effective against a bona fide purchaser, although I have been unable to find a source that actually says this. Some secret liens are effective against real estate, though I suspect that most are not. *See North Gate Corp. v. North Gate Bowl, Inc.*, 149 N.W.2d 651, 654–55 (1967). The court in *North Gate* discusses a former federal tax statute that was later revised because it created the undesirable—though not impermissible—result of creating a secret lien. *See id.* To be safe it is most advisable to require filing against any real estate and make this requirement crystal clear in the statute itself. The statute should also specify where the lien must be filed.

Admittedly, I have lingering doubts about whether bankruptcy courts will consistently uphold unfiled statutory liens against personal property either, even if there is full compliance with a state statute. According to the most comprehensive research that has been done on statutory liens, most statutory liens do not fare well against voluntary lien-holders because lien statutes normally fail to address the priority of the lien. *See Meredith S. Jackson & Jennifer L. Kercher, Report of the ABA Business Law Section Uniform Commercial Code Committee, Subcommittee on Relation to Other Law, Re: Inclusion of Nonpossessory Statutory Liens in Article 9*, 51 CONSUMER FIN. L.Q. REP. 108, 110 (1997).

<sup>227</sup> Existing statutes address these issues in a variety of ways. Arizona's statute requires the director to record a notice of lien in favor of residents as a condition to

lien probably should be either first or second only to the primary lender.<sup>228</sup> While it could weaken residents' collateral position, it is probably necessary to provide in the statute that the residents' lien can be subordinated, to permit the facility to obtain additional financing when needed.

The most common form of statutory lien in favor of residents makes filing a lien in favor of residents optional. California, New Hampshire, New Jersey, Pennsylvania, and Vermont have enacted statutes that permit the commissioner or agency in charge of CCFs to file a statutory lien whenever the commissioner finds it is in the best interests of residents.<sup>229</sup> Pennsylvania's statute provides that:

Prior to the issuance of a certificate of authority under this act or at such other times as the commissioner may determine it in the best interests of residents of a facility, the commissioner may file a lien on the real and personal property of the provider or facility to secure the obligations of the provider pursuant to existing and future contracts for continuing care.<sup>230</sup>

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granting a permit. *See* ARIZ. REV. STAT. § 20-1805 (1998). The lien takes priority over all subsequent liens and may be subordinated by the director against any subsequent first mortgage liens or other long-term financing. *See id.* The Texas statute, by comparison, provides that a lien in favor of residents automatically attaches to the facility's property when a resident first occupies the premises. *See* TEX. HEALTH & SAFETY CODE ANN. § 246.111 (West Supp. 2000). This lien is subordinate to any first mortgage used for construction or any subsequent refinancing. The lien may be removed by the commissioner if the facility is financially sound and if removing the lien will not harm residents. It is unclear why this statute provides for the complete removal of the lien rather than just further subordination. Moreover, practically speaking, it is unlikely that the commissioner will take a decision to remove the lien lightly. The commissioner would need to determine that the facility is sound, and that removing the lien would not harm residents.

<sup>228</sup> The reason that the lien may need to be prioritized second to the primary secured lender, rather than first, is that it may be impossible to get a lender to lend to a CCF if the resulting lien is always second to the claims of residents. Thus, market realities need to be considered when determining the priority of resident liens. Providing for subordination when deemed necessary could at least partially solve this problem, although the discretion involved in making a decision about subordination could cause other problems. *See infra* notes 229–32 and accompanying text.

<sup>229</sup> *See* CAL. HEALTH & SAFETY CODE § 1793 (West Supp. 2000); N.H. REV. STAT. ANN. § 420-D:8 (1998); N.J. STAT. ANN. § 52:27D-341 (West Supp. 1999); 40 PA. CONST. STAT., § 3211 (1992); VT. STAT. ANN. tit. 8, § 8004 (Supp. 1999).

<sup>230</sup> 40 PA. CONST. STAT., § 3211 (1992). These liens are valid for 10 years and can be extended if the commissioner deems it necessary for these liens to be foreclosed, with the proceeds used to pay claims of residents. Their priority falls behind a first mortgage on real property but presumably ahead of all other consensual and non-consensual liens. However, the lien may be subordinated with the commissioner's written consent, if advisable for the efficient

While these discretionary statutes are not per se invalid under section 545, they may be voidable as a practical matter, because the statutes leave it up to the discretion of the commissioner whether to file a lien.<sup>231</sup> If a commissioner decides to file a lien after certification, based upon concerns for financial viability, the statute would probably be voidable under the spirit of section 545(1).<sup>232</sup> Yet it is hard to imagine any other reason why a commissioner would decide to impose such a lien after certification. Moreover, from a practical perspective, exercising the right to create a discretionary lien in favor of residents subjects the commissioner to potential lawsuits by both facilities management and residents. Imposing a lien by discretion could make it impossible for a facility to obtain financing or to refinance. It could cause a lender to call a loan into default and could have other negative financial ramifications for the facilities. As a result, mandatory lien statutes, which are effective automatically are more effective, perhaps with voluntary subordination where necessary.

When enacting statutory liens, there is one additional factor to consider. While a valid statutory lien is better than no lien, these liens do have their limitations. Once a bankruptcy is filed, if the statutory lien does not take priority over voluntary security interests, their relatively junior priority can make the liens worthless.<sup>233</sup> Most bankruptcy debtors have little equity in their assets over and above that required to satisfy voluntary secured creditors.<sup>234</sup> This means

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operation of the facility. *See id.*

The big question raised by statutes in this form is whether the filing of such a lien simply perfects the lien or also creates the lien. Under Article 9 of the Uniform Commercial Code, attachment occurs when, among other things, the debtor signs a security agreement. *See* U.C.C. § 9-203 (1994) (revised 1977). This security interest can then be perfected by filing a U.C.C.-1 financing statement. *See* U.C.C. § 9-301. While attachment and perfection could take place simultaneously, through one event, as in certain narrow situations under Article 9, *see, e.g.*, U.C.C. §§ 9-302, 9-308, 9-309, this is somewhat uncommon.

<sup>231</sup> *See* 11 U.S.C. § 545 (1994).

<sup>232</sup> *See id.*

<sup>233</sup> Statutory liens that do not take priority over consensual security interests receive compensation from the debtor only after voluntary secured claims are satisfied in full from the proceeds of the secured property. *See de Wolf, supra* note 208, at 169 (discussing this issue in the context of environmental liens imposed by states). Outside bankruptcy, the effect of these statutes on state priorities varies depending on the specific statute. Some state statutes, such as New York's garagemen's lien, take priority over voluntary secured liens, assuming that the work done by the garagemen was necessary to protect or preserve the collateral. Under most state statutes, however, statutory liens created by statute are lower in priority than security interests created by agreement. *See id.* (discussing how most environmental statutory liens are losing in priority to consensual security interests).

<sup>234</sup> *See id.* (stating that a bankruptcy debtor is more likely than most other debtors to have granted other consensual security interests, leaving few assets left to satisfy statutory lien holders).

that, practically speaking, the lien may provide no benefit because there may be no assets left to collateralize it.<sup>235</sup> These liens are certainly worth enacting but do not guarantee protection for residents in the event of insolvency.

In summary, enacting a statutory lien that is effective only upon bankruptcy or insolvency does not provide residents with a secured claim in the facility's bankruptcy, and may even encourage CCFs to file for bankruptcy by creating an incentive to avoid the liens. Similarly, enacting a statute creating "preferred status" for residents does not create a lien. Enacting discretionary lien provisions is also risky because it is unclear whether such liens survive a section 545 analysis. The most effective statutory liens are those that are imposed and perfected automatically by statute upon certification or the first residency, and that make the resident lien first in priority but subject to subordination, if necessary and appropriate. This form of lien survives bankruptcy, and assuming there are assets available to satisfy such claims, will protect residents to the highest extent possible.<sup>236</sup>

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<sup>235</sup> The practical result of having a secured claim in property that has insufficient value to cover the claim is that the "secured" claim becomes an unsecured claim. *See id.* (stating that a secured claim without collateral from which to collect becomes an unsecured claim, that often provides little or no payment); *see also* 11 U.S.C. § 506(a) (stating that a secured claim is secured "to the extent of the value of such creditor's interest in the estate's interest in such property . . . and is an unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim").

<sup>236</sup> Most CCF statutes also give residents a right to organize for the purpose of exercising some quality control over their living conditions. *See, e.g.*, FLA. STAT. ch. § 651.018 (West 1996); IOWA CODE ANN. § 523D.6 (1998); ME. REV. STAT. ANN. tit. 24-A, § 6227 (West 2000); MD. ANN. CODE art. 70B, § 13 (Supp. 1999); N.H. REV. STAT. ANN. § 420-D:15 (1998); N.J. STAT. ANN. § 52:27D-345 (West Supp. 1999); N.M. STAT. ANN. § 24-17-13 (Michie 1997); N.C. GEN. STAT. § 58-64-40 (1996); OHIO REV. CODE ANN. § 173.13 (Anderson 1994). Some statutes provide for specific resident grievance procedures that are more narrowly defined than the general right to organize, *see* WIS. STAT. § 647.04 (1996), and some provide for specific roles for residents on resident committees and boards of directors, *see, e.g.*, MICH. COMP. LAW § 544.812 (West 1993); OHIO REV. CODE ANN. § 173.13 (Anderson 1994); N.Y. PUB. HEALTH LAW § 4612 (McKinney Supp. 1999); N.C. GEN. STAT. § 58-64-40 (1996); R.I. GEN. LAWS § 23-59-11 (1997); VA. CODE ANN. § 38.2-4910 (Michie 1999). Drafters of statutes who do not address residents' rights regarding organizing, filing grievances, or participating in management may simply have felt that these rights were too obvious to even mention. I certainly hope that is the reason for the omission.

The right to organize, and to participate in some way in the quality of care received, seems fundamental and obvious. These provisions provide few real rights to residents, however, and in some cases, provide a painful reality check about the lack of control and dignity many people have—even in these relatively upscale facilities. Statutes discussing residents' rights often provide for meetings between management and residents and some minimal participation by at least one resident in facility decisionmaking processes. Most of the provisions provide very few opportunities to actually participate in any meaningful way, however, and thus, the



#### 4. *State Rehabilitation Provisions*

Various states have attempted to create rehabilitative powers in a commissioner or other person or department in charge of CCFs in that state.<sup>237</sup> Many of these provisions are unenforceable because they purport to give the state, rather than the bankruptcy court, power over both state insolvencies and bankruptcies.<sup>238</sup> While states probably cannot exercise the control they desire over CCF insolvencies, it is possible that states can preclude CCFs from filing for bankruptcy.<sup>239</sup> One question worth asking is whether giving such control to states would benefit residents. If so, there may be ways to provide this control to states.

A common provision allows the appropriate state official to institute a state rehabilitation or insolvency proceeding, if the facility becomes insolvent, improperly uses reserve funds, or goes bankrupt.<sup>240</sup> In all but the last instance, these statutes are effective initially but do not create much benefit for residents.

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provisions appear to be pro forma. Some common residents' rights provisions are demeaning to residents, such as the common provision stating that "no retaliatory conduct shall be permitted against any resident for membership or participation in a residents' organization or for filing any complaint." VA. CODE ANN. § 38.2-4910 (Michie 1999). Florida, which probably has as much experience with continuing-care as any state, is extremely explicit about what a resident gets in exchange for his or her enormous entrance fee: "[T]he right to (a) Live in a safe and decent environment, free from abuse and neglect. (b) Be treated with consideration and respect and with due recognition of...the need for privacy. (c) Unrestricted private communication . . . . (e) Exercise civil and religious liberties." FLA. STAT. ch. 651.083 (West 1996). It is as if without providing these rights statutorily, a resident would not have them. Yet, as United States citizens they are still entitled to the same constitutional and other protections as everyone else. It is disturbing that these needs must be spelled out.

Residents' rights provisions do not violate the Supremacy Clause and would certainly be upheld in bankruptcy. In fact, specifically providing the right to organize by statute might encourage residents to do so, which could be helpful if a bankruptcy is filed. The residents would already have an organized means by which to participate in the bankruptcy case as a group. It might also encourage residents to request a separate residents committee in a Chapter 11 case, which could greatly improve their treatment in the case.

<sup>237</sup> See, e.g., ARIZ. REV. STAT. § 20-1808(D) (1998); FLA. STAT. ch. 651.119 (1996); N.H. REV. STAT. ANN. § 420-D:16 (1998); S.C. CODE ANN. § 37-11-105 (Law. Co-op Supp. 1999); TEX. HEALTH & SAFETY CODE ANN. § 246.092 (West 1992).

<sup>238</sup> See *infra* notes 239–56 and accompanying text.

<sup>239</sup> See *infra* notes 257–83 and accompanying text.

<sup>240</sup> See, e.g., ARIZ. REV. STAT. § 20-1808(C), (D) (1998); CONN. GEN. STAT. § 17b-532(a) (1998); TEX. HEALTH & SAFETY CODE ANN. § 246.092 (West 1992). South Carolina provides that CCFs may, among other requirements, have to submit a financial plan to the department, detailing the methods by which the CCF proposes to overcome the deficiencies noted by the department. See S.C. CODE ANN. § 37-11-105 (Law. Co-op Supp. 1999).

Once a facility is put into receivership, it is still free to file for federal bankruptcy protection,<sup>241</sup> which could hurt residents more than it will help them.<sup>242</sup>

Many of these rehabilitation provisions are modeled after similar provisions for insurance company insolvencies. Insurance companies are not eligible for bankruptcy, therefore their insolvency proceedings are always in state court.<sup>243</sup> Moreover, state funds are established to compensate failed insurance companies' customers, who are generally made whole regardless of the type of insolvency proceeding involved.<sup>244</sup> Because CCFs are generally eligible for bankruptcy, placing a facility in a state insolvency proceeding may simply cause the facility to file for protection under Chapter 11, where its rights vis-à-vis residents are even greater.<sup>245</sup> Moreover, a statute providing that a state can put a CCF into receivership after it has filed a bankruptcy petition simply will not be upheld. The federal bankruptcy court will already have jurisdiction over the case under the Bankruptcy Code, which preempts the state statute.<sup>246</sup>

For the same reason, legislation purporting to take powers away from the bankruptcy court also violates the Supremacy Clause. Many statutes provide that the state official may move for the appointment of a trustee, a provision that may or may not be upheld.<sup>247</sup> For example, the Texas statute provides that whenever a facility improperly uses its reserves, or is at risk of insolvency, the commissioner *must* request that the Attorney General move for an order of insolvency or for the appointment of a trustee.<sup>248</sup> Of course, when deciding such a motion, the bankruptcy court will decide whether to appoint a trustee in a reorganization case, based on the rights of all parties in interest in the case, not based solely on a demand made by the state.<sup>249</sup>

Some statutory provisions create other supremacy problems. For example, New Hampshire's statute provides that in any liquidation of a facility, the proceeds of the liquidation shall be used to pay resident entrance fees at other facilities or be otherwise used for the benefit of residents.<sup>250</sup> This provision flies

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<sup>241</sup> See 11 U.S.C. § 109(b) (1994); *In re Florida Brethren Homes, Inc.*, 88 B.R. 445, 447 (Bankr. S.D. Fla. 1988).

<sup>242</sup> See *infra* Part IV.

<sup>243</sup> See 11 U.S.C. § 109.

<sup>244</sup> See Patrick Collins, Note, *HMO Eligibility for Bankruptcy: The Case for Federal Definitions of 109(b)(2) Entities*, 2 AM. BANKR. INST. L. REV. 425, 447 (1994).

<sup>245</sup> See *infra* notes 284–305 and accompanying text.

<sup>246</sup> See *supra* notes 111–22 and accompanying text.

<sup>247</sup> See, e.g., N.H. REV. STAT. ANN. § 420-D:16 (1998); TEX. HEALTH & SAFETY CODE ANN. § 246.092 (West 1992).

<sup>248</sup> See TEX. HEALTH & SAFETY CODE ANN. § 246.092 (West 1992).

<sup>249</sup> See 11 U.S.C. § 1104 (1994).

<sup>250</sup> See N.H. REV. STAT. ANN. § 420-D:16(IV) (1998). Interestingly, the New Hampshire

in the face of the Bankruptcy Code priority system, which articulates in detail the order of payment to general unsecured creditors.<sup>251</sup>

Another goal of some CCF statutes is to give residents standing in any case filed by a CCF. Minnesota's statute, for example, provides residents standing to move for the appointment of a trustee.<sup>252</sup> Some statutes require any bankruptcy court or any commissioner in a state receivership to consider the interests of residents in adjudicating the CCF's case.<sup>253</sup> The residents already have standing in the case because they are creditors of the facility.<sup>254</sup> When a state statute directs the court to consider the residents' interests, however, it is not clear which interests the court should consider. Presumably, the court considers residents' interests differently from the interests of other creditors. In other words, to consider residents' noneconomic as well as their economic interests. While I certainly feel that a federal bankruptcy court should consider all of these interests,<sup>255</sup> I question whether a state is in a position to order a bankruptcy court to do so. Congress recently passed federal bankruptcy legislation that would give patients in all health care facilities standing in any bankruptcy case filed by such a facility.<sup>256</sup> This would be preferable to state legislation granting residents standing, which may or may not be binding on federal bankruptcy courts. This and all other CCF legislation relating to rehabilitation and insolvency is potentially preempted and thus potentially unenforceable.

#### *E. The Enforceability of State Statutes that Make CCFs Ineligible for Bankruptcy*

There may actually be a solution to the supremacy problems facing CCF statutes that is within states' control. States may be able to make all of their otherwise preempted legislation valid by treating their CCFs as insurance

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legislature must have known that this provision did not create a lien, because it has a separate provision allowing the commissioner to grant residents a lien, if necessary to protect them. *See id.* § 420-D:5(II).

<sup>251</sup> *See* 11 U.S.C. § 507.

<sup>252</sup> *See* MINN. STAT. § 80D.11 (1999).

<sup>253</sup> *See id.*; N.H. REV. STAT. ANN. § 420-D:16(IV) (1998); N.J. STAT. ANN. § 52:27D-346(f) (West Supp. 1999); 40 PA. CONST. STAT. § 3216(f) (1992).

<sup>254</sup> Maryland's statute, which provides that CCF residents shall be deemed creditors in any CCF bankruptcy, states the obvious. *See* MD. ANN. CODE art. 70B, § 21 (Supp. 1999).

<sup>255</sup> *See generally* Martin, *supra* note 152, at 446-61, 464-65 (discussing the obligations of bankruptcy courts to consider both economic, as well as noneconomic, interests when deciding an issue in a case).

<sup>256</sup> The Bankruptcy Reform Act of 1999 is currently in conference committee. *See* H.R. 833, 106th Cong. § 1104 (1999).

companies under state law.<sup>257</sup> In every state in the nation, domestic insurance companies are ineligible for bankruptcy under section 109(b) of the Bankruptcy Code<sup>258</sup> because they are subject to regulated state liquidation and rehabilitation proceedings.<sup>259</sup> One state, Maine, has enacted a statute that provides that CCFs are insurance companies and are subject only to the state liquidation and rehabilitation laws for insurance companies.<sup>260</sup> While this may be an ineffective attempt to override the clear eligibility requirements of the Bankruptcy Code, it is possible that such a provision would be upheld, thus precluding CCFs in the state of Maine from maintaining a bankruptcy case.

While no court has decided whether a CCF may be deemed an insurance company, several courts have decided the analogous issue of whether an HMO may be deemed an insurance company during insolvency proceedings. Somewhat surprisingly, half of the courts deciding this issue have held—at least indirectly—that Congress has delegated to the states the determination of what constitutes an insurance company for the purposes of section 109(b).<sup>261</sup>

Three separate tests have been used to decide if an HMO constitutes an insurance company, which have created wildly inconsistent results. Under the “state classification” test, the test used by the only circuit court to decide this issue, courts generally defer to a state’s own classification of whether an entity constitutes an insurance company.<sup>262</sup> Assuming the state has set up a full regulatory scheme for liquidating or rehabilitating these entities, and assuming

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<sup>257</sup> See, e.g., ME. REV. STAT. ANN. tit. 24-A, § 6225 (West 2000).

<sup>258</sup> 11 U.S.C. § 109 (1994).

<sup>259</sup> See S. REP. NO. 95-989, at 31 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 5817; Collins, *supra* note 244, at 447.

<sup>260</sup> See ME. REV. STAT. ANN. tit. 24-A, § 6225 (West 2000).

<sup>261</sup> Compare *In re Estate of Medicare HMO*, 998 F.2d 436, 446 (7th Cir. 1993) (holding that HMOs were both “classified explicitly [under Illinois law] as insurance companies excluded from bankruptcy protection, [and] that HMOs [were] also the substantial equivalents of domestic insurance companies”); *In re Beacon Health, Inc.*, 105 B.R. 178, 186–87 (Bankr. D.N.H. 1989) (holding that an HMO was a “domestic insurance company” within the meaning of §§ 109(b) and 109(d) and finding that, “[f]rom the viewpoint of the subscriber/policy holder, there [was] no functional difference between an HMO and an insurance company”); *In re Family Health Servs., Inc.*, 101 B.R. 636, 640–43 (Bankr. C.D. Cal. 1989) (holding that HMOs are eligible for bankruptcy relief for several reasons: (1) they are not specifically excluded under section 109; (2) Louisiana statutes distinguish between HMOs and insurers; (3) HMOs differ significantly from insurance companies; and (4) the fact that HMOs are regulated and liquidated under a state statutory scheme does not make them the substantial equivalent of insurance companies); *In re Michigan Master Health Plan, Inc.*, 90 B.R. 274, 275 (E.D. Mich. 1985) (holding that an HMO “certainly was not an insurance company under Michigan state law”).

<sup>262</sup> See *Medicare HMO*, 998 F.2d at 442.

the resulting state liquidations are regulated by the insurance commissioner, the state's classification will generally be upheld.<sup>263</sup> Form cannot entirely prevail over substance even under this test, however, so the entity must also share the essential attributes of an insurance company.<sup>264</sup> For some courts, this means that the HMO must assume a third party's risk in exchange for a premium.<sup>265</sup> For others, the entity or HMO must be quasi-public.<sup>266</sup>

Under the second test, the "independent classification" test, courts are asked to look to section 109, rather than state law, to determine what Congress' intention was in enacting section 109 and to determine if the section is exhaustive or illustrative.<sup>267</sup> Under one court's analysis, if Congress wanted to make HMOs ineligible for bankruptcy, it could have done so expressly.<sup>268</sup> Thus, most courts using this test have held that HMOs are not insurance companies. Under the third test, the "alternative relief" test, courts ask whether, assuming there is a state regulatory scheme in place, the goals of the Bankruptcy Code can be equally served by allowing the state to exclude the entity from bankruptcy

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<sup>263</sup> See *id.* at 442-43; *Beacon Health*, 105 B.R. at 183-84.

<sup>264</sup> See *Medcare HMO*, 998 F.2d at 445; *Beacon Health*, 105 B.R. at 185 n.1 ("Suffice it to say that if a sign is placed on the neck of a duck saying it is 'not a duck' that doesn't mean it is not a duck."); *Family Health Servs., Inc.*, 101 B.R. at 643 ("Whether or not HMOs are regulated and liquidated under a state statutory scheme . . . is of little assistance in deciding whether an HMO is the substantial equivalent of an insurance company under state law.").

<sup>265</sup> See *In re Portland Metro Health, Inc.*, 15 B.R. 102, 105 (Bankr. D. Or. 1981) (stating that insurance involves risk spreading and an indemnity element).

<sup>266</sup> See *Medcare HMO*, 998 F.2d at 446; *Beacon Health*, 105 B.R. at 181. Plenty of quasi-public entities are eligible for bankruptcy, however, including utilities, hospitals, and even municipalities. Thus, I fail to see the significance of this factor in determining eligibility for bankruptcy.

<sup>267</sup> See *In re Family Health Servs., Inc.*, 101 B.R. 636, 639-40 (Bankr. C.D. Cal. 1989).

<sup>268</sup> See *In re Beacon Health, Inc.*, 105 B.R. 178, 179-80 (Bankr. D.N.H. 1989); *Family Health*, 101 B.R. at 640. These two cases reach different results, though purporting to apply the same test. In *Beacon Health*, Judge Yacos analyzed whether the HMO in issue was the "substantial equivalent" of an insurance company. He ultimately concluded that it was, despite the fact that the HMO contract in issue did not contain an indemnity relationship. Although Judge Yacos claims to have applied the "independent classification" test, his analysis was more similar to the "state classification" test. See *Beacon Health*, 105 B.R. at 186. In *Family Health*, by contrast, the court looked at the legislative history of section 109, and concluded that Congress knew about the existence of HMOs and still failed to exclude them from bankruptcy protection under section 109. See *Family Health*, 101 B.R. at 640. The decision in *Family Health* is somewhat weakened by a subsequent district court decision, reversing a decision that a Wisconsin affiliate was eligible for bankruptcy, due to particular provisions in that state's laws. See *Selcke v. Medcare HMO*, 147 B.R. 895 (N.D. Ill. 1992), *aff'd*, *In re Medcare HMO*, 998 F.2d 436 (7th Cir. 1993). Naturally, however, whether an entity constitutes an HMO depends not only on the tests used by the courts, but also on particular provisions of state law.

eligibility.<sup>269</sup> This test considers the interests of all the parties, tries to balance them, and then determines what is best for all involved.<sup>270</sup> This test resembles a “police powers” analysis in some respects, which is comforting given that this ultimately is a preemption issue.<sup>271</sup> None of the tests are all that different in any event.<sup>272</sup> All three look to see if the entity in issue resembles an insurance company. The main difference is in the presumption of validity, and whether it favors state law, the intention of the Bankruptcy Code drafters, or general public policy.

While HMOs and CCFs are analogous in some ways, there are also differences between them. As far as patients or consumers are concerned, HMOs are insurance companies, or are at least closely related to a company that provides health insurance.<sup>273</sup> CCFs are a hybrid between a nursing home and a provider of annuities. While the former is clearly eligible for bankruptcy, the latter may not be. HMOs are also far more heavily regulated than CCFs. They are governed by state legislation in forty-seven states as well as by federal legislation.<sup>274</sup> There is a model HMO statute, which provides that HMOs are insurance companies for the purposes of liquidation or rehabilitation.<sup>275</sup> HMOs typically have an indemnity component, whereas CCFs do not.<sup>276</sup> Thus, CCFs share fewer of the attributes of an insurance company and are subject to less state regulation.

While it is impossible to determine whether this provision in Maine’s statute

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<sup>269</sup> See *Family Health*, 101 B.R. at 644.

<sup>270</sup> See *id.*

<sup>271</sup> It is unclear how these three tests fit with the general supremacy analysis or with a “police powers” analysis. See *supra* notes 111–67 and accompanying text. The Seventh Circuit in *Medcare HMO* acknowledged that this issue is ultimately a supremacy question, that must be analyzed under *Perez v. Campbell*. See *In re Estate of Medcare HMO*, 998 F.2d 436, 442 (7th Cir. 1993) (citing *Perez v. Campbell*, 402 U.S. 637, 652 (1971)). Thus, it is necessary to ask whether the state’s classification of HMOs frustrates the full effect of the Bankruptcy Code. See *id.* at 442.

<sup>272</sup> See *id.* (stating that all three tests require the same thing, namely an analysis of the “actual operation” of the HMO, the impact of the state classification on the objectives of the Bankruptcy Code, plus a determination of whether excluding HMOs from bankruptcy protection is consistent with the policies of the code).

<sup>273</sup> See *Medcare HMO*, 998 F.2d at 444 (noting that whether an HMO is licensed under the HMO Act or the Insurance Code is without consequence to the services the HMO provides its enrollees).

<sup>274</sup> See Jay M. Howard, *The Aftermath of HMO Insolvency: Considerations for Providers*, 4 ANNALS HEALTH L. 87, 93–95 (1995) (discussing federal regulation of HMOs).

<sup>275</sup> See HEALTH MAINTENANCE ORG. MODEL ACT § 21(A) (Nat’l Assoc. Ins. Comm’rs 1995).

<sup>276</sup> See *In re Medcare HMO*, 998 F.2d 436, 445 (7th Cir. 1993).

would be upheld, particularly given the split of authority on the issue in the HMO industry, the possibility is not foreclosed. If states were to enact a provision such as Maine's and it were deemed enforceable, this would make virtually every supremacy problem raised in this Article moot. In addition to adding the "insurance" language, however, states that wish to control this issue must liquidate CCFs under the provisions of the insurance statutes, must fully integrate CCFs into their insurance industry scheme, and must appoint the commissioner of insurance to regulate the industry.<sup>277</sup> Just calling a CCF an insurance company is not enough to make the CCF ineligible for bankruptcy.

One court briefly considered whether a CCF constituted an insurance company for the purpose of Chapter 11 eligibility, but in that case, none of the above requisites had been met.<sup>278</sup> The statute at issue did not state that CCFs were insurance companies and provided no scheme under which to liquidate CCFs under state law.<sup>279</sup> Language in the case implies, however, that if these problems were solved, a CCF might well be an insurance company, if a state statute says that it is.<sup>280</sup> Somehow, it seems hard to believe that this could be effective—any more than calling a duck a rabbit would turn it into a rabbit.<sup>281</sup> It still seems worth a try, however. Legislating that CCFs are insurance companies would express a state's clear intention regarding control of these cases, and it would be more valuable than much of the current legislation that is preempted without this additional language.<sup>282</sup>

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<sup>277</sup> See *Medcare HMO*, 998 F.2d at 446; *In re Beacon Health, Inc.*, 105 B.R. 178, 181 (Bankr. D.N.H. 1989). There is disagreement about whether HMOs must use the liquidation and rehabilitation procedures in order to qualify as insurance companies, or whether they can instead have their own tailored provisions. The *Beacon Health* court held that because the HMO at issue in that case was to be liquidated under the statute in exactly the same way as an insurance company, it was an insurance company. See *Beacon Health*, 105 B.R. at 178. Another case held, however, that HMOs can constitute insurance companies under section 109, even if the statute provides for separate and different liquidation procedures for HMOs. See *Medcare HMO*, 998 F.2d at 445.

<sup>278</sup> See *In re Florida Brethren Homes, Inc.*, 88 B.R. 445, 446–47 (S.D. Fla. 1998).

<sup>279</sup> See *id.*

<sup>280</sup> See *id.* (stating that, assuming the state's legislative classification did make the CCF involved an insurance company, the CCF was still eligible for bankruptcy because the Florida statute did not provide an alternative provision for liquidation of the CCF under the circumstances).

<sup>281</sup> See *Beacon Health*, 105 B.R. at 185 n.1.

<sup>282</sup> Given the almost desperate attempts by states to control CCF insolvencies, it is surprising that only one state has enacted legislation proclaiming CCFs to be insurance companies. It makes one wonder what tipped off Maine and why Maine has kept its own information a secret. In fact, the enormous discrepancies in the various aspects of the CCF statutes makes national coordination very desirable.

In summary, states have enacted a host of legislation relating to the insolvency and reorganization of CCFs which expresses a clear desire to exercise power, control, and jurisdiction over CCF insolvencies. Many of these provisions are ineffective in federal bankruptcy cases because most states are currently unable to preclude a CCF from filing for bankruptcy protection. This makes many continuing-care statutes worthless at the very time when residents need them most. There may be a way to enforce these provisions, as well as the others previously discussed. Specifically, states can attempt to make CCFs ineligible for bankruptcy, leaving states free to enforce their entire regulatory scheme in state court. I am not convinced that this will work, but find the prospect interesting.

Perhaps all of the provisions giving states power over bankruptcy cases, as well as state attempts to make CCFs ineligible for bankruptcy, can also be enforced through the police power exception to the automatic stay. The questions to answer include: (1) is this uniquely a local domain, such that states should be left unfettered to regulate it, and (2) do these provisions actually protect the health and safety of citizens to the extent necessary to fit within section 364(d)(4)? There is no clear answer to either question. Continuing-care is an area of heavy state regulation and to some extent, the concerns seem local. Once insolvency occurs, however, there is no reason to believe that the resulting cases are best handled locally under state insolvency statutes, or that states should be telling bankruptcy courts how to adjudicate their cases. Moreover, it would seem inconsistent to deny access to bankruptcy to the CCFs in one state but not to those in another state. In short, there seems to be no reason to defer to the states on the subject of CCF insolvencies.<sup>283</sup> Rather, it would be more effective to provide extra protection to residents by amending the Bankruptcy Code to remove some of the incentives to file.

#### IV. ADDRESSING CCF INSOLVENCIES THROUGH THE BANKRUPTCY CODE

Chapter 11 provides many important rehabilitation mechanisms, but one of the most powerful is contract rejection.<sup>284</sup> The debtor-in-possession has the option to either assume the contract, in which case the contractual obligations become administrative expenses of the estate,<sup>285</sup> or to reject the contract, which

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<sup>283</sup> This conclusion could be incorrect, however, because the current Bankruptcy Code creates the wrong incentives for CCFs, who benefit too much in federal bankruptcy cases, at the expense of residents. In a sense, facilities have been able to externalize costs in a way generally precluded in the environmental context. Moreover, residents are at great risk of loss in facility bankruptcies. Perhaps residents can be protected against this risk by moving all of the cases to state forums where states can control them.

<sup>284</sup> See 11 U.S.C. § 365(a) (1994).

<sup>285</sup> See *id.* § 503. Unlike prepetition unsecured claims that can be paid at a very low rate



relieves the debtor of all obligations to perform the contract, and leaves the nondebtor party with a claim for damages.<sup>286</sup> This damages claim is paid at a rate of far less than one hundred percent, typically, at about ten percent of its original value.<sup>287</sup>

When it comes to contract rejection, fairness does not come into play at all. Although they are courts of equity, bankruptcy courts are not permitted to balance the interests of the parties. They must instead allow rejection if doing so will benefit the debtor.<sup>288</sup> Rejection is permitted because, in order to rehabilitate a business, one must be free to discard unprofitable obligations.<sup>289</sup> As a result,

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of distribution, see Jay Lawrence Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN L. REV. 227, 252–53 (1989) (calling the dollars distributed to unsecured creditors tiny “bankruptcy dollars”), administrative claims must be paid in full by the debtor, making the decision to assume unsecured claims very important and potentially costly. See 11 U.S.C. § 503(b)(1)(A). As a result, courts look far more critically at a debtor’s decision to assume than a decision to reject, as a poor decision could destroy the debtor’s business, and thus reduce returns to creditors. See *In re Food City, Inc.*, 94 B.R. 91, 92 (Bankr. W.D. Tex. 1988); 1 DAVID G. EPSTEIN ET AL., *BANKRUPTCY* 231, 245 (1992).

<sup>286</sup> See 11 U.S.C. § 365(g). Section 365(g) treats the breach as a prepetition breach by the debtor. See *id.* The nondebtor party then becomes a creditor, as defined in section 101(10)(B). See *id.* § 101 (10)(B). Section 502(g) then classifies the nondebtor party’s rejection damage claim as a general unsecured claim. See *id.* § 502(g).

<sup>287</sup> There is no one definitive study indicating the average bankruptcy distribution to unsecured creditors. However, the several studies that have been completed show that most companies that successfully reorganize in Chapter 11 pay distributions of 15% or less. See Susan Jensen-Conklin, *Do Confirmed Chapter 11 Plans Consummate? The Results of a Study and Analysis of the Law*, 97 COM. L.J. 297, 322–23 (1992) (finding that of 42 confirmed reorganization plans, 7 paid unsecured creditors less than 10%, 15 paid between 10% and 16%, 11 paid between 16% and 30%, and 1 paid 53%); Robert M. Lawless et al., *A Glimpse at Professional Fees and Other Direct Costs in Small Firm Bankruptcies*, 1994 U. ILL. L. REV. 847, 869 (1994) (finding that in 27 small Chapter 11 cases, 15 paid distributions of less than 10%, 7 cases between 11% and 20%, and 5 between 21% and 60%). But see Michelle J. White, *Bankruptcy Costs and the New Bankruptcy Code*, 38 J. FIN. 477, 483 (1983) (stating that distributions generally fell below 32%). A 10% distribution has become a common “benchmark” or estimate of what a hypothetical case might pay in distributions, so some scholars have come to assume that the average case does pay 10%. See Westbrook, *supra* note 285, at 253, 289 (assuming a 10% distribution in his hypothetical involving the rejection of a contract to sections). Of course, some cases pay even less. See, e.g., *United Food & Commercial Workers Local Union v. Appletree Mkts., Inc. (In re Appletree Mkts., Inc.)*, 155 B.R. 431, 435 n.1 (S.D. Tex. 1993) (noting that the union’s contract damages were between \$7 million and \$11 million, and that as unsecured creditors, the union would get 8 cents on the dollar, but as a party to a breached postpetition contract, the union would recover on their claim in full).

<sup>288</sup> See *In re A.J. Lane & Co.*, 107 B.R. 435, 440–41 (Bankr. D. Mass. 1989).

<sup>289</sup> Section 90(b) of the Bankruptcy Act also contained a similar provision, 11 U.S.C. § 110(b) (repealed 1978), as did the Bankruptcy Act of 1938, which provided that a trustee had

the Bankruptcy Code permits the rejection of most contracts freely, including continuing-care contracts.<sup>290</sup> This could create a strong incentive for a CCF to file for Chapter 11 in order to rid itself of unprofitable resident continuing-care contracts.

The Code recognizes that although debtor rehabilitation is important, some nondebtor parties to contracts have equally important, or perhaps even more important, interests. As a result, Congress has limited or prohibited contract rejection in some situations in order to protect these particular nondebtor parties. This Part analyzes how and why this special protection was provided to certain nondebtor parties to see if similar legislation might be appropriate to protect CCF residents. After discussing how CCF contract rejection could be limited by further bankruptcy legislation, this Part discusses another general way to protect residents, namely by creating a higher priority for their claims, either by making their claims secured through effective state legislation, or by giving their contract rejection claims priority status under section 507 of the Bankruptcy Code. Finally, this Part considers the option of simply making CCFs ineligible for bankruptcy through an amendment to the Bankruptcy Code.

### *A. The Problems Created by Section 365's Rejection Powers*

One has to wonder what Congress was thinking when it enacted section 365 of the Bankruptcy Code.<sup>291</sup> By giving debtors the virtually unlimited ability to

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to be able to abandon burdensome property whenever doing so was in the best interests of the estate. See 2 COLLIER ON BANKRUPTCY § 365.01, at 365-68 (Lawrence P. King ed. 1996).

<sup>290</sup> At least one court has found that CCF contracts are rejectable—no other reported opinions discuss the issue. See *In re Bretheren's Home*, 24 B.R. 336, 339 (Bankr. S.D. Ohio 1982). While I am currently conducting empirical research regarding whether there is any difference of opinion on this subject among courts that have considered the issue in nonreported opinions, there certainly is no exception for life care contracts in section 365. See 11 U.S.C. § 365 (1994).

If rejection is indeed possible, the incentive to reject contracts is always present when someone pre-pays for a service or right that he will enjoy over a long period of time. I remember the bankruptcy of Sullivan Stadium in Boston in the late 1980s. The Chapter 11 trustee moved to reject the superbox contracts, pursuant to which big companies paid tens of thousands of dollars to use luxury superboxes, for a period of one to ten years. Rejection created obvious benefits. If the old users could have been replaced with new "paying" customers, the debtor could have benefited from the same space twice. The same incentive is created here. If residents who have already paid for the care can be replaced with new residents, the debtor can both raise the contract fee and collect twice.

<sup>291</sup> The idea that contracts could be rejected had its origins in the English common law doctrine that permitted bankruptcy trustees to abandon burdensome property. See 2 COLLIER ON BANKRUPTCY, *supra* note 289, at 365-16, 365-17; see also Vern Countryman, *Executory Contracts in Bankruptcy*, (pt. 1) 57 MINN. L. REV. 439, 460 (1973). According to the

reject or disavow contracts, debtors have a powerful incentive to file for bankruptcy.<sup>292</sup> Section 365(a) of the Bankruptcy Code allows a debtor to assume or reject any contract, subject to bankruptcy court approval, under the "business judgment" test.<sup>293</sup> Generally, one need not show that a contract is particularly burdensome in order to reject it, but only that the debtor would be better off without it.<sup>294</sup> Rejection constitutes a breach of the contract, permanently releasing the debtor of all performance obligations, and leaving the nondebtor party with only the right to file a general unsecured claim for damages.<sup>295</sup>

As if it were not enough to allow complete disavowal of a contract that is otherwise enforceable,<sup>296</sup> section 365 and the cases interpreting it, create a host

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legislative history of section 365, Congress' primary goal in enacting the section was to allow debtors to shirk off unprofitable business obligations, similar to the way a trustee is permitted to abandon any unprofitable asset. *See* S. REP. NO. 95-989, at 58-60 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5844; H.R. REP. NO. 95-595, at 347-50 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 6303; *see also* Westbrook, *supra* note 285, at 248-49.

<sup>292</sup> This is particularly true of debtors with large contractual obligations that they no longer wish to perform. Rejection is permitted with very little judicial scrutiny under the applicable business judgment test. *See In re A. J. Lane & Co.*, 107 B.R. 435, 439 (Bankr. D. Mass. 1989); *see also In re Sombrero Reef Club, Inc.*, 18 B.R. 612, 617 (Bankr. S.D. Fla. 1982) (holding that rejection should be denied only where the trustee's decision based solely on profitability of the contract to the debtor is clearly erroneous).

<sup>293</sup> The business judgment test is virtually a no-brainer for courts, which must simply decide if rejection is financially beneficial to the debtor. *See* EPSTEIN ET AL., *supra* note 285, at 244-45 (noting that some courts interpret the business judgment test as requiring no review of a rejection decision); *A.J. Lane*, 107 B.R. at 439; *Sombrero Reef*, 18 B.R. at 617. According to another court, the only issue in a rejection case is "whether the decision of the debtor that rejection will be advantageous is so manifestly unreasonable that it could not be based on sound business judgment, but only on bad faith, or whim or caprice." *In re Constant Care Community Health Ctr., Inc.*, 99 B.R. 697, 709 (Bankr. D. Md. 1989) (citing *Lubrizol Enter. v. Richmond Metal Finishers, Inc.*, 765 F.2d 1043, 1047 (4th Cir. 1985)).

<sup>294</sup> *See A.J. Lane*, 107 B.R. at 439; *Sombrero Reef*, 18 B.R. at 617. Jay Howard's informative article on HMO bankruptcies contains an interesting and almost upbeat discussion about what doctors and other professionals can do to protect themselves while they are waiting to see if their contracts are rejected. *See* Howard, *supra* note 274, at 104-05. Despite its hopeful tone, the answer is still "not much."

<sup>295</sup> *See* 11 U.S.C. §§ 365(g)(1), 502; Christopher D. Cameron, *How "Necessary" Became the Mother of Rejection: An Empirical Look at the Fate of Collective Bargaining Agreements on the Tenth Anniversary of Bankruptcy Code Section 1113*, 34 SANTA CLARA L. REV. 841, 850 (1994).

<sup>296</sup> Section 365(a) states that the trustee may assume or reject any executory contract or unexpired lease. *See* 11 U.S.C. § 365(a) (1994). Through section 1107, the debtor-in-possession in a Chapter 11 has the same right. *See id.* § 1107. The most common definition of an "executory" contract is "a contract under which the obligation of both the [debtor] and the other party to the contract are so far unperformed that the failure of either to complete

of unfair imbalances during the waiting period, while the debtor decides whether to reject or disavow the contract or perform under it.<sup>297</sup> During at least some of this time period, the debtor is allowed to ignore its own payment and performance obligations under the contract, while at the same time enforcing the contract against the nondebtor party.<sup>298</sup> In some cases, courts have forced

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performance would constitute a material breach excusing the performance of the other." Countryman, *supra* note 291, at 460. Under the more modern "functional" approach, the focus is not so much on the contract, but rather on the debtor's benefits and burdens under it. See Michael T. Andrew, *Executory Contracts in Bankruptcy: Understanding "Rejection,"* 59 U. COLO. L. REV. 845, 892-93 (1988). Under this analysis, whether a contract is executory only matters if the debtor wants to assume it. See *id.* at 890. If the debtor does not want to assume it, then no matter what the obligation is called, it is nothing more than an unsecured claim for damages. See *id.*; see also Westbrook, *supra* note 285. Under Professor Westbrook's analysis, one looks at the debtor's required performance and the future benefits to be gained by the debtor. Then one determines whether it makes sense for the debtor to assume the contract and thus perform it or reject the contract and cease performance of it. See *id.* at 335-36. While one hornbook claims that Westbrook's definition is similar to Countryman's rather than Andrew's, see EPSTEIN ET AL., *supra* note 285, at 245, I do not see much difference between the Andrew approach and the Westbrook approach. See also S. REP. NO. 9-89, at 58 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5844; H.R. REP. NO. 95-595, at 347 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 6303. Rejection frees the debtor from all obligations to perform the contract. But rejection also constitutes a default or breach under the contract, requiring the debtor to pay the nondebtor party a distribution on any resulting unsecured claim for damages resulting from the breach. See 11 U.S.C. § 502(b)(6); *Wainer v. A.J. Equities Ltd.*, 984 F.2d 679, 684 (5th Cir. 1993). After such a distribution is made, and of course it can be quite small in percentage, the remainder of the damages claim is discharged. See *Wainer*, 984 F.2d at 684.

<sup>297</sup> Section 362(a) prevents unilateral action by the nondebtor party to a contract. See 11 U.S.C. § 362(a). Until rejection, however, the contract is fully binding on the nondebtor party and the debtor-in-possession can obtain an injunction directing the other party to perform. See *Data-Link Sys., Inc. v. Whitcomb & Keller Mortgage, Inc. (In re Whitcomb & Keller Mortgage, Inc.)*, 715 F.2d 375, 378-79 (7th Cir. 1983) (enforcing a contract for computer services); *Continental Energy Assocs. L.P. v. Hazleton Fuel Management Co. (In re Continental Energy Assocs. Co.)*, 178 B.R. 405, 408 (Bankr. M.D. Pa. 1995); *Chuck Smith Ford, Inc. v. Ford Motor Credit (In re Chuck Smith Ford, Inc.)*, 46 B.R. 515, 519 (Bankr. M.D. Fla. 1985); *Ike Kempner & Bros., Inc. v. U.S. Shoe Corp. (In re Ike Kempner & Bros., Inc.)*, 4 B.R. 31, 32-33 (Bankr. E.D. Ark. 1980) (enforcing a shoe supplier contract).

Moreover, an assumable contract is not enforceable against the debtor-in-possession before assumption. See *Skeen v. Denver Coca-Cola Bottling Co. (In re Feyline Presents, Inc.)* 81 B.R. 623, 627 (Bankr. D. Colo. 1988) (holding that the nondebtor party can be liable to the debtor for breaching the contract during the "limbo" period but that the debtor need not perform).

<sup>298</sup> Pending the debtor's decision whether to assume or reject an executory contract, the nondebtor party must continue to perform. See *Continental Energy Assocs. L.P. v. Hazleton Fuel Management Co. (In re Continental Energy Assocs. Co.)*, 178 B.R. 405, 409 (Bankr. M.D. Pa. 1995). In fact, according to one recent decision, the main purpose of section 365(a) is to relieve the debtor of burdensome obligations, while at the same time providing a means

suppliers to deliver goods to debtors against their will, and have even been willing to reduce the price the debtor must pay for such goods below the contract price.<sup>299</sup>

This discussion merely demonstrates that there is nothing unusual about the rejection of a contract. All rejections are unfair to the nondebtor party. While allowing rejection may seem unfair, this important Bankruptcy Code benefit was purposefully provided by Congress to aid rehabilitation.<sup>300</sup>

Nevertheless, if there is a particularly good reason to prohibit or limit some rejections, it can be done. Congress has chosen to make rejection more difficult for certain types of contracts and leases, most notably real estate leases to which the debtor is the landlord,<sup>301</sup> software license agreements to which the debtor is

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through which the debtor can force the nondebtor party to continue to perform under the contract. *See In re Chateaugay Corp.*, 10 F.3d 944, 954–55 (2d Cir. 1993).

<sup>299</sup> *See Continental Energy*, 178 B. R. at 409. In *Continental Energy*, the Chapter 11 debtor operated a cogeneration facility. The debtor sought a preliminary injunction to compel a fuel supplier to continue to deliver natural gas essential to the debtor's operations pending the debtor's decision to assume or reject the parties' gas supply contract. Hazleton Fuel Management Company ("Hazleton") did not want to continue to supply gas to the debtor pending assumption or rejection of the contract because the debtor had threatened to seek disgorgement by Hazleton of any payment made over and above the reasonable cost of such natural gas. The debtor did not want to assume the gas supply contract because it did not have an immediate alternative source of natural gas, although the market rate for gas was significantly lower than the contract rate. *See id.* at 407.

Hazleton argued that it could not be compelled to perform under the contract on terms different than provided in the contract. Although Hazleton refused to deliver the fuel at less than the contract price, the court granted the requested relief pursuant to Bankruptcy Code section 105. *See id.* at 407–08. The court reasoned that the debtor would be paying in advance and would be paying at least as much as determined to be "reasonable amounts" for the fuel. Further, the debtor was required to assume or reject the contract within thirty days of the preliminary injunction hearing. Thus, "Hazleton's 5th Amendment rights [were] vigilantly being guarded by [the] court." *Id.* at 407. The court left open the determination of the price ultimately to be paid for the fuel. This essentially compelled performance by a nondebtor party to a contract prior to assumption or rejection, on terms that were potentially different than those required by the contract.

<sup>300</sup> *See id.*

<sup>301</sup> *See* 11 U.S.C. § 365(h). This section provides that if the debtor is the landlord under an unexpired real estate lease, the debtor landlord can reject the tenant's real estate lease. Further, this section provides that the tenant has the right to choose to remain in tenancy on the premises and set off any expenses related to the tenancy against the rent due. *See id.* Because this is typically unprofitable for the debtor-landlord, the section generally discourages debtor-landlords from rejecting tenant leases. *See, e.g., In re Lee Rd. Partners, Ltd. v. F.W. Woolworth Co.*, 169 B.R. 507, 512 (E.D.N.Y. 1994) (noting that due to the provisions of section 365(h), there would be no benefit to granting a motion to reject a lease to which the debtor is the landlord, and thus the motion should be denied); *In re Friarton Estates Corp.*, 65 B.R. 586, 593 (Bankr. S.D.N.Y. 1986) (noting that the tenants in a rent controlled building

the licensor,<sup>302</sup> time share interests to which the debtor is the time share interest seller,<sup>303</sup> real property leases under which the debtor is an airline that leases aircraft gates from an airport,<sup>304</sup> and collective bargaining agreements to which the debtor is the employer.<sup>305</sup> The question is whether continuing-care contracts to which the debtor is the CCF should be added to this list.

### 1. *Limitations on Rejection of Certain Real Estate Leases, Time Shares, and License Contracts*

Real estate leases to which the debtor is the landlord, timeshare interests to which the debtor is the timeshare interest seller, and license agreements to which the debtor is a licensor, are all treated in similar ways under the Bankruptcy Code.<sup>306</sup> These interests in property cannot be eliminated as easily as other

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could not be removed from the debtor's apartments through rejection of their contracts).

<sup>302</sup> See 11 U.S.C. § 365(n)(3) (1994). This section provides that while the debtor-licensor to a software agreement can reject its contract with the licensee, the licensee can choose to retain certain rights under such contract, including retention to all software received as well as some updates of the software. However, the licensee must continue to pay for the software and make any royalty payments. It is not permitted to set off or reduce its royalty payments to the debtor to take into account the debtor-licensee's nonperformance. See also *Encino Bus. Management, Inc. v. Prize Frize, Inc.* (*In re Prize Frize, Inc.*), 32 F.3d 426, 428-29 (9th Cir. 1994) (holding that after the debtor's rejection of patent for its french fry machine, the licensee who chose to retain the software was required to make other outstanding "royalty payment as well as" monthly installment payments); *In re El Int'l*, 123 B.R. 64, 66 (Bankr. D. Idaho 1991) (interpreting section 365(n) and holding that if the licensee elects to retain its rights under the agreement, the licensee must make all royalty payments and further is deemed to waive any right to setoff and any section 503(b) claim the licensee may have against the bankruptcy estate). Compare 11 U.S.C. § 365(n)(2), with 11 U.S.C. § 365(h).

<sup>303</sup> See 11 U.S.C. § 365(h)(2)(A). Purchasers of real property under a loan installment contract, who are in possession of the property, also receive special protections. See *id.* § 365(i).

<sup>304</sup> See *id.* § 365(d)(5). This provision was added to the Bankruptcy Code to protect the public and the transportation industry. See H.R. REP. NO. 95-595 (1977), reprinted in 1978 U.S.C.A.N. 5787, 6199; see also *Western Pac. Airlines, Inc. v. GATX Capital* (*In re Western Pac. Airlines, Inc.*), 221 B.R. 1, 10 (Bankr. D. Colo. 1998) (discussing the purposes of section 365(d)(5) and related section 1110). Because this situation is so different from that of CCF residents, this code section is not analyzed here.

<sup>305</sup> See 11 U.S.C. § 1113; see also *infra* notes 348-89 and accompanying text.

<sup>306</sup> Compare 11 U.S.C. §§ 365(h)(1), (2), with 11 U.S.C. § 365(n)(3). Under both sections, the nondebtor party to the contract can opt to maintain certain rights under the contract, even after rejection. For example, tenants to real estate leases can remain in possession of leased premises and licensees can maintain possession of the licensed software. See *id.* §§ 365 (h)(1), (n)(3). Section 365(h)(2) also significantly limits the debtor's ability to reject timeshare interests. See *id.* § 365(h)(2). The big difference between the two is that tenants

leases and contracts in bankruptcy, although a debtor can easily reject its own tenant's interest in a lease.<sup>307</sup> Real estate leases to which the debtor is the landlord create a real property interest in favor of the tenant.<sup>308</sup> Under section 365(h) of the Bankruptcy Code, a debtor technically is permitted to reject a real estate lease to which it is a landlord.<sup>309</sup> If the debtor does reject the leases, however, the tenants can choose to continue to occupy the premises.<sup>310</sup> Moreover, while the debtor need not provide any essential services to the tenants after rejection, the tenants have the right to offset any expenses they incur to obtain replacement services at the leased premises against the rent owed the debtor-landlord.<sup>311</sup> This right of set-off makes it financially infeasible for most

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to real estate leases can set off the costs of essential services against the rent due, while the licensee to a rejected software agreement cannot set off the cost of services it fails to get from the debtor. *See id.* § 365(h)(1)(B), § 365(n)(2)(C)(i).

<sup>307</sup> Section 365(a), which permits rejection, applies to the debtor-tenant's interest in a lease, as this particular interest does not fall within the exception described in section 365(h). Section 365(h) applies only to rejection of the landlord's interest in a real estate lease. *See id.* § 365(a), § 365(h)(1)(A); *see also id.* § 365(e) (allowing a landlord whose tenant has assumed a lease to request an additional security deposit, and making it clear that the debtor can alternatively reject the lease).

In several nursing home cases in which the debtor was the nursing home operator, as well as a tenant under a lease for the building, courts have acknowledged the debtor nursing homes' unequivocal right to reject the tenant's interest in such premises. *See, e.g., In re Care Givers, Inc.*, 113 B.R. 263, 268 (Bankr. N.D. Tex. 1989) (holding that a lease for nursing home premises was not a nonresidential lease that had to be assumed within 60 days of the filing because residents lived there, and acknowledging in dicta that if the debtor had wanted to reject its lease, it could have done so); *In re Sonora Convalescent Hosp., Inc.*, 69 B.R. 134, 137-38 (Bankr. E.D. Cal. 1986) (holding that a lease of convalescent home premises that has not been assumed was automatically rejected 60 days after the filing); *In re Independence Village, Inc.*, 52 B.R. 715, 722 (Bankr. E.D. Mich. 1985) (holding that a facility lease was not a nonresidential real property lease but implicitly acknowledging that such a lease could be rejected).

<sup>308</sup> *See* 11 U.S.C. § 365(h) (1994). The legislative history of § 365(h) indicates that Congress' goal was to retain the former Bankruptcy Act's policy of preserving tenants possessing real estate tenancy. *See id.* § 110(b) (repealed 1978). The idea was to preserve the expectation of the real estate transaction parties by codifying the balance between the competing interests of the parties. *See In re Lee Rd. Partners, Ltd.*, 155 B.R. 55, 60 (Bankr. E.D.N.Y. 1993), *aff'd*, 169 B.R. 507 (Bankr. E.D.N.Y. 1994).

<sup>309</sup> *See* 11 U.S.C. § 365(h).

<sup>310</sup> *See id.*

<sup>311</sup> *See id.* Section 365(h) was structured to preserve the lessee's possessory interest in the leasehold, while at the same time relieving the debtor-lessor of the obligation to provide continuing services to the lessee, presumably because some debtors would be financially unable to provide these services in any event. *See Lee Rd. Partners*, 155 B.R. at 60.

debtor-landlords to actually reject the contracts.<sup>312</sup> As a result, debtors rarely reject their landlord's interest in a real property lease.<sup>313</sup>

One important benefit to a nondebtor tenant that flows from section 365(h)(1) is that if the debtor sells its real estate, it cannot sell it free and clear of the tenant's interests.<sup>314</sup> Thus, just as would be the case outside bankruptcy, the tenant's possessory interest is retained regardless of who owns the leased property.<sup>315</sup>

When timeshare interests became popular in the 1980s, one debtor who sold time shares rejected the contracts creating such an interest.<sup>316</sup> While the timeshare interest purchasers tried to argue that their interests constituted leases under existing section 365(h)<sup>317</sup> and were thus protected from dispossession, the court was unwilling to find the timeshare interests to be "real property interests," and thus within the protection of existing section 365(h).<sup>318</sup> Thereafter, Congress decided that holders of timeshare interests should be protected from rejection and enacted section 365(h)(2).<sup>319</sup> Congress provided this protection to timeshare interest holders, even though that they do not qualify as true "real property

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<sup>312</sup> As some authors have noted, reported opinions on section 365(h) are rare. See Thomas C. Homburger et al., *Conflict Resolved: Bankruptcy Code § 365(h) and the Contradictory Cases Requiring Its Amendment*, 29 REAL PROP. PROB. & TR. J. 869, 873 (1995). Because the requirements of section 365(h) are onerous, most debtor-lessors do not reject tenant leases. Instead, most debtor-lessors view the income stream from tenant leases as part of the estate's assets, and simply continue the tenancy as usual. See *id.* at 873-74.

<sup>313</sup> See *id.*; see also *Lee Rd. Partners*, 169 B.R. at 512.

<sup>314</sup> See 11 U.S.C. §§ 365(h), 363(b) (1994).

<sup>315</sup> Despite the section 363(f) claims that a debtor can sell its property "free and clear of all interests," see *id.* § 363(f), section 365(h) clearly trumps 363(f). See *In re Churchill Properties III*, 197 B.R. 283, 287 (Bankr. N.D. Ill. 1996) (stating that section 365 was more compelling and ruled the day over section 363(f)).

<sup>316</sup> See, e.g., *In re Sombrero Reef Club, Inc.*, 18 B.R. 612, 620 (Bankr. S.D. Fla. 1982). *Sombrero Reef* was the only case reported on the issue of rejection of timeshares prior to enactment of section 365(h)(2). According to a later court decision, *Sombrero Reef* led to the enactment of section 365(h)(2). See *In re Sombrero Reef Club, Inc.*, 89 B.R. at 992-93 (deciding on the amount of compensation due debtor's counsel in this case, given the novelty of the issues involved and the fact that the case led to amendment of the Bankruptcy Code). In light of this, it seems unbelievable that residents of life care contracts are not already protected from rejection in section 365. It is hard to believe this legislation was not enacted in 1980, right after the court in *Brethren's Home* permitted the rejection of life care contracts. See *In re Brethren's Home*, 24 B.R. 336, 339 (Bankr. S.D. Ohio 1982).

<sup>317</sup> At the time, section 365(h) only applied to tenants holding leasehold interests.

<sup>318</sup> See *Sombrero Reef*, 18 B.R. at 612-18 (concluding that the timeshare contracts did not constitute leases under section 365(h), and while the owners had purchased "something" with their initial fee—that something did not seem to be an interest in real property).

<sup>319</sup> See 11 U.S.C. § 365(h)(2).



interests," and that doing so unquestionably hinders a timeshare seller's rehabilitation.<sup>320</sup>

Not long after enacting the timeshare legislation, Congress enacted special legislation to protect a third interest group from contract rejection—licensees to software license agreements.<sup>321</sup> Before section 365(n) was enacted, section 365(a) allowed a debtor in possession or trustee to reject software licenses, which would cause the licensed material to revert back to the debtor and become property of the debtor's estate.<sup>322</sup> Because software licensees were unusually dependent on licensors, some courts felt licensees needed extra protection from rejection.<sup>323</sup> Moreover, Congress feared that the United States, a clear leader in software technology, would begin losing its competitive edge in the world market if licensees could lose all of the value of their software license whenever an American licensor filed for bankruptcy protection.<sup>324</sup> As a result, Congress enacted section 365(n), which essentially provides that, while a debtor-licensor can reject a software license agreement, the licensee can retain its rights under

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<sup>320</sup> See Mark C. Eriks, Note, *Treatment of Time-Share Interests Under the Bankruptcy Code*, 59 IND. L.J. 223, 248–49 (1984). This student note, apparently written just before Congress enacted section 365(h)(2), concludes that timeshare interest holders do not present a strong case for special priority under section 365(i) because timeshares are used only for vacation and the loss of this right would not result in the holders being displaced from their homes. See *id.* at 243. The author further notes that this protection would be provided at a great cost to the debtor, whose only business might be selling timeshares. See *id.* at 250–51. Despite this fine logic and an almost complete lack of case law or legal commentary describing the need for this special protection, this legislation sailed right through. See 130 CONG. REC. S20013, S20083 (June 29, 1984) (statement of Sen. Dole), reprinted in 1984 U.S.C.C.A.N. 586, 587.

<sup>321</sup> See 11 U.S.C. § 365(n) (1994).

<sup>322</sup> See *id.* § 365(a).

<sup>323</sup> See *Lubrizol Enters. v. Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers, Inc.)*, 756 F.2d 1043, 1048 (4th Cir. 1985). But see *In re Logical Software, Inc.*, 66 B.R. 683, 686–87 (Bankr. D. Mass. 1986) (rejecting any notion that software license agreements were different from other agreements, and thus allowing rejection under the business judgment test). In many respects, the *Lubrizol* case led to the enactment of section 365(n). In that case, the court recognized that it had no choice but to allow rejection under section 365(a), but clearly stated that it wished it could also consider the severe harm that would result to the licensee. The licensee in *Lubrizol* was going to lose its entire business if rejection were permitted. See *Lubrizol*, 756 F.2d at 1048. Moreover, according to the court, this would have a "chilling effect" on the development of intellectual property. See *id.*

<sup>324</sup> See Marjorie F. Chertok, *Structuring License Agreements with Companies in Financial Difficulty: Section 365(n)—Divining Rod or Obstacle Course?*, 65 ST. JOHN'S L. REV. 1045, 1046 (1991); Mary A. Moy, Comment, *The Intellectual Property Bankruptcy Protection Act: An Unbalanced Solution to the International Software Licensing Dilemma*, 11 U. PA. J. INT'L. BUS. L. 151, 153–54 (1989).

the contract, including the right to continue to use the software, enforce any exclusivity provision, and protect its confidential information.<sup>325</sup>

Each of these pieces of specialty legislation was enacted for a different reason.<sup>326</sup> Starting with tenant real estate laws under section 365(h), Congress was continuing the policy of the old Bankruptcy Act of elevating state-created property interests above bankruptcy laws.<sup>327</sup> Apparently, Congress also wanted to preserve the benefit of the tenant's bargain.<sup>328</sup> As the legislation protecting timeshare interest holders demonstrates, however, Congress did not feel that it could only protect nondebtor parties with recognized real property interests.<sup>329</sup> Congress protected timeshare interest holders with specialty legislation, despite the lack of a real property interest in their favor, and even though those timeshare interests could be the only items that some debtors have to sell.<sup>330</sup> Licensees to software contracts were protected for still different reasons, namely to protect the party with presumably less bargaining power and to protect the market for U.S. software licenses in general.<sup>331</sup>

While too much specialty legislation can make the bankruptcy process

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<sup>325</sup> See 11 U.S.C. § 365(n). The debtor is not required to provide any additional services to the licensee, however, and need not continue updating the software. *See id.* Moreover, the licensee cannot offset this maintenance or other costs against the license fees it owes the debtor and must continue paying the license fees pursuant to the contract terms. *See id.*

According to at least one author, Congress may have gone too far in protecting licensees in enacting section 365(n). *See Moy, supra* note 324, at 186–91. Ms. Moy would rather see courts balance the interests of both parties and then decide how to rule based on the relative harms and benefits. *See id.* at 192. Another author, however, feels that the purpose of enacting section 365(n) was to ameliorate what he calls judicial “rejection abuse,” resulting from too much reliance by bankruptcy courts on traditional bankruptcy mechanisms—even when considering the rejection of an intellectual property license. *See John P. Musone, Comment, Crystallizing the Intellectual Property Licenses in Bankruptcy Act: A Proposed Solution to Achieve Congress’ Intent* 13 BANKR. DEV. J. 509, 524–34 (1997). Accordingly, Ms. Musone also favors a “balancing of interests” approach over section 365(n), although obviously for different reasons. *See id.*

<sup>326</sup> *See supra* notes 307 and 319–25 and accompanying text.

<sup>327</sup> *See supra* note 307 and accompanying text.

<sup>328</sup> *See id.*

<sup>329</sup> See 11 U.S.C. § 365(h)(2) (1994); *see also* Eriks, *supra* note 320, at 250.

<sup>330</sup> *See id.* at 250–51. As Mr. Eriks notes, timeshare interest holders are protected at the expense of rehabilitation of the timeshare seller. *See id.* This is, of course, true in the case of all of the section 365 specialty legislation.

<sup>331</sup> *See supra* notes 321–25 and accompanying text. It was most likely the threat of losing the world-wide competitive edge in intellectual property that led Congress to enact section 365(n). I find it hard to believe that it was an imbalance of power that fueled this legislative effort because power imbalances are present in contracts of many different kinds, including many areas for which no special section 365 protection is provided.

inefficient, none of these special interest groups seem any more deserving of special protection from section 365(a) than CCF residents. History does elevate real property interests above bankruptcy rights,<sup>332</sup> but it is not necessary to hold a real property interest in order to be worthy of section 365(a) protection.<sup>333</sup> Similar to timeshare interest holders, CCF residents do not hold a recognizable property interest in their facility.<sup>334</sup> CCF residents' interests in their CCF contracts are certainly more important than the interests that timeshare holders have in their vacation timeshares.<sup>335</sup> CCF residents' interests also seem more compelling than the interests of software licensees. While it is true that rejection of a licensee's software license could put the licensee out of business, this is also true of many nondebtor parties subject to rejected contracts.<sup>336</sup> By comparison, CCF residents could be removed from their homes at a time in life when relocation often results in death.<sup>337</sup> Finally, the financial incentives to reject seem greater in the CCF context than in these other contexts. This would be true anytime a nondebtor party made a huge prepayment at the beginning of a contract and paid very little money under the contract terms thereafter, but this is exacerbated when the contract term is potentially very long.<sup>338</sup>

Assuming that residents should be protected through some form of bankruptcy legislation, section 365 could be used as a model for such legislation. Such legislation need not mimic existing provisions of the Bankruptcy Code in protecting CCF residents, however. The best solution might be different from that provided in section 365, based on the different needs of both residents and CCFs. All specialty legislation found in sections 365(h) and (n) allows the debtor to reject certain contracts while providing that the nondebtor party can retain

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<sup>332</sup> See *supra* note 307 and accompanying text.

<sup>333</sup> See 11 U.S.C. § 365(h)(2) (protecting timeshare interest holders); *id.* § 365(n)(3) (protecting licensees to software contracts).

<sup>334</sup> See *supra* notes 93–95 and accompanying text.

<sup>335</sup> Timeshares are typically used for vacations and never, as far as I know, as a primary residence.

<sup>336</sup> Commentators and courts think that software license contracts present this problem. See Chertok, *supra* note 324, at 1046–47; Moy, *supra* note 324, at 190; see also *Lubrizol Enters. v. Richmond Metal Finishers, Inc. (In re Richmond Metal Finishers, Inc.)*, 756 F.2d 1043, 1048 (4th Cir. 1985). However, this result can occur in any industry.

<sup>337</sup> Moving can be very taxing on an elderly person. Even moving an elderly person from one room in a nursing home to another can be frightening and traumatic. See Marilyn Denny, *This Is Who I Am, Don't Let Them Move Me: Autonomy in Nursing Homes*, 2 QUINNIPIAC HEALTH L.J. 203, 204 (1999).

<sup>338</sup> Obviously, a debtor-CCF facility cannot make money (or even stay in business) if it has spent all of the residents' entrance fees and has no way to raise more entrance fees without replacing existing residents.

certain rights with respect to the property in issue.<sup>339</sup> CCF residents are probably most similar to tenants in real estate leases or to holders of timeshare interests.<sup>340</sup> Under a provision similar to section 365(h), a debtor facility could reject its CCF contracts, but the residents would have the right to continue residing in the facility.<sup>341</sup> While a debtor would be free of its obligations to provide essential services to the residents, under a provision similar to sections 365(h)(1) and 365(h)(2), residents could obtain such services elsewhere and then set off the resulting costs against the amounts it owes the debtor.<sup>342</sup> This precise model would not protect residents, however, because residents have prepaid for lifetime nursing care and would have few, if any, ongoing obligations to the debtor from which to set off the costs of essential services. Moreover, some residents would have no way to pay for such services while waiting for reimbursement from the debtor.

The goal in looking to section 365(h) for guidance is not to replicate its language exactly, but to create the same practical result that section 365(h)(1) has created, namely to make it infeasible for debtor-CCFs to reject resident contracts.<sup>343</sup> The incentives are completely different in the two different situations, however. Debtor-lessors view their on-going rental stream as an asset and thus keep their tenant leases in place in order to continue receiving that income.<sup>344</sup> CCFs, on the other hand, typically have little ongoing income from existing residents.<sup>345</sup>

One way to replicate the result created by section 365(h) would be to permit residents to receive essential services from third parties, who would then have a direct right to be paid by the debtor, an administrative expense claim in the amount of the cost of such services.<sup>346</sup> This would discourage rejection, but I am

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<sup>339</sup> See 11 U.S.C. §§ 365(h)(1), 365(h)(2), 365(n) (1994).

<sup>340</sup> Compare *id.* § 365(h)(1), with *id.* § 365(h)(2). The main difference is that tenants may set off the costs of essential services against the rent paid. In addition, the timeshare interest holder can set off the value of any damage caused by the debtor's nonperformance against any amounts still owed to the debtor. The main difference between section 365(h) and section 365(n) is that under the latter, licensees can retain the software in question, but cannot set off the costs of servicing and updating the software, which the debtor is no longer providing. Obviously, a statute modeled on this provision would provide no protection to residents. It would do them no good whatsoever to be able to stay in the facility.

<sup>341</sup> See *id.* §§ 365(h)(1), 365(h)(2).

<sup>342</sup> See *id.*

<sup>343</sup> See *supra* notes 309–13 and accompanying text.

<sup>344</sup> See *supra* note 312 and accompanying text.

<sup>345</sup> See *supra* notes 62–69 and accompanying text.

<sup>346</sup> This would be quite unusual. I can think of no other Bankruptcy Code provision that creates rights in third parties, but that does not mean that it cannot be done.

not sure other service providers would want to extend credit to a facility with obvious financial problems. Another alternative to drafting legislation that merely creates strong disincentives to rejection would be simply forbidding or severely limiting the right to reject these kinds of contracts, as has been done with collective bargaining agreements.<sup>347</sup>

## 2. *The Treatment of Collective Bargaining Agreements in Bankruptcy*

Rather than permitting rejection, but making it unprofitable, Congress took an entirely different tack in addressing the question of whether collective bargaining agreements could be rejected in bankruptcy.<sup>348</sup> Collective bargaining agreements have always been treated somewhat differently than other contracts in bankruptcy, in recognition of their special status under the National Labor Relations Act (NLRA).<sup>349</sup> Prior to the enactment of special legislation in favor of labor unions, in order to decide how and whether rejection could be achieved, one needed to compare the language and policies of two federal statutes, the National Labor Relations Act and the Bankruptcy Code,<sup>350</sup> and balance the interests at stake. On the question of whether collective bargaining agreements could be rejected, the two federal statutes are clearly at odds.<sup>351</sup>

Congress ultimately enacted very special protections against rejection of a

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<sup>347</sup> See *infra* notes 348–89 and accompanying text.

<sup>348</sup> See 11 U.S.C. § 1113 (1994) (providing that collective bargaining agreements could only be rejected under very unusual circumstances and after jumping through many hoops).

<sup>349</sup> See *id.*; 29 U.S.C. §§ 151–69. The NLRA was enacted in 1935, to rectify the inequality of bargaining power between labor and management. See *id.* § 151. As this section provides:

The inequality of bargaining power between employees who do not possess full freedom of association or actual liberty of contract, and employers who are organized in the corporate or other forms of ownership association substantial burdens and affects the flow of commerce, and tends to aggravate recurrent business depressions, by depressing wage rates and the purchasing power of wage earners in industry and by preventing the stabilization of competitive wage rates and working conditions within and between industries.

*Id.*; see also David L. Gregory, *Labor Contract Rejection in Bankruptcy: The Supreme Court's Attack on Labor in NLRB v. Bildisco*, 25 B.C. L. REV. 539, 543–44 (1984) (stating that before federal labor legislation, employers dominated the work).

<sup>350</sup> See 29 U.S.C. §§ 151–69; 11 U.S.C. §§ 101–1330.

<sup>351</sup> While the NLRA tried to protect employees, see *id.* § 151, the Bankruptcy Code's goal for reorganizing a company was primarily to rehabilitate the debtor company (management) and create the largest distribution possible for creditors. See *supra* notes 151–52 and accompanying text.

collective bargaining agreement.<sup>352</sup> In doing so, Congress protected the labor-employee parties to the contract and made rejection extremely difficult for management-employer debtors.<sup>353</sup> Congress sent a strong message to employers of organized labor, namely that while bankruptcy serves many goals, union busting is not one of them.<sup>354</sup> In other words, bankruptcy could not be used solely to reject a collective bargaining agreement.<sup>355</sup> Current bankruptcy legislation precludes this result primarily by providing that collective bargaining agreements can only be rejected or modified to the extent "necessary to permit the reorganization of the debtor."<sup>356</sup> A number of other procedural and substantive steps are also required before a collective bargaining agreement can be rejected, if it can be rejected at all.<sup>357</sup>

The current law regarding the rejection of collective bargaining agreements was enacted after the Supreme Court's decision in *NLRB v. Bildisco &*

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<sup>352</sup> See 11 U.S.C. § 1113 (providing the steps necessary to and the specific circumstances under which a company could reject a collective bargaining agreement).

<sup>353</sup> According to some courts, a collective bargaining agreement can only be rejected if a failure to do so will result in imminent liquidation of the debtor. See *United Steelworkers of Am. v. Wheeling-Pittsburgh Steel Corp.* (*In re Wheeling-Pittsburgh Steel*), 791 F.2d 1074, 1085 (3d Cir. 1986) (stating that when Congress required that contracts could be rejected only when management's proposed contract modifications were "necessary" to the debtor's reorganization, it meant that absent the modification, the debtor could not survive). *But see* *Truck Drivers Local 807 v. Carey Transp., Inc.*, 816 F.2d 82, 89 (2d Cir. 1987) (adopting a far less stringent standard for debtors rejecting collective bargaining agreements and instead requiring only that the proposed modification, or out-and-out rejection, increase the likelihood of reorganization).

<sup>354</sup> See 130 CONG. REC. S8653, S8887 (Apr. 11, 1984) (remarks of Sen. Thurmond), reprinted in 1984 U.S.C.C.A.N., at 583. As Senator Thurmond stated, by requiring that rejection be "necessary" to reorganization, debtors would be prevented from using a bankruptcy filing merely to rid themselves of features of the labor contract that have no bearing on their financial condition.

<sup>355</sup> See *id.*

<sup>356</sup> See 11 U.S.C. § 1113(b)(1)(A) (1994).

<sup>357</sup> See *id.* In total, section 1113 requires that the debtor complete nine steps before rejecting a collective bargaining agreement, which are described in detail in Cameron, *supra* note 295, at 845-46.

The nine steps are: (1) The debtor must make a union proposal; (2) that is based on the most complete financial information available; (3) provides for those modifications to the existing contract that are necessary to permit the debtor's reorganization; (4) the modifications must treat all effected parties fairly and equitably; (5) the debtor must provide the union with information necessary to evaluate the proposal; (6) the debtor must meet with the union to discuss the proposal; (7) the debtor must meet in good faith; (8) the union must refuse to accept the proposal without good cause; and (9) the balance of equities must favor rejection.

Professor Cameron notes, however, that courts seem fixated on the necessity requirement rather than the other eight requirements. See *id.* at 841.

*Bildisco*,<sup>358</sup> which one commentator called a “devastating blow” to labor.<sup>359</sup> After balancing the interests of both labor and management, the *Bildisco* court allowed rejection of the collective bargaining agreement because it was expensive to the debtor’s estate.<sup>360</sup> While the Court admitted that the test for rejection of a collective bargaining agreement should be somewhat higher than the business judgment test and that balancing the equities was required, it did not flesh out the details.<sup>361</sup> Labor groups immediately lobbied Congress to enact legislation repealing *Bildisco*, which they claimed gutted section 8(a)(5) of the NLRA and made union busting an appropriate goal for Chapter 11.<sup>362</sup> Simultaneous to responses to much larger issues being raised about bankruptcy court power and jurisdiction, Congress quickly passed section 1113.<sup>363</sup>

Section 1113 attempts to merge the goals of the Bankruptcy Code and the NLRA, by requiring a Chapter 11 debtor to negotiate with an authorized union representative before rejecting a collective bargaining agreement.<sup>364</sup> Moreover, a court may not approve rejection unless it finds, among other things, that: (1) the

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<sup>358</sup> See *NLRB v. Bildisco & Bildisco (In re Bildisco)*, 465 U.S. 513 (1984).

<sup>359</sup> See Gregory, *supra* note 349, at 588.

<sup>360</sup> See *id.*

<sup>361</sup> See *Bildisco*, 465 U.S. at 526. The Court rejected a strict rejection standard that would require the debtor in possession to show that liquidation would invariably occur absent court-authorized rejection. See *id.* Ironically, the Second Circuit had adopted a strict standard, but once section 1113 was adopted, it began adopting a more lenient interpretation of section 1113 than many courts. Compare *Truck Drivers Local 807 v. Carey Transp., Inc.*, 816 F.2d 82, 89 (2d Cir. 1987), with *United Steel Workers of Am. v. Wheeling-Pittsburgh Steel Corp.*, 791 F.2d 1074, 1085 (3d Cir. 1986).

<sup>362</sup> See Cameron, *supra* note 295, at 866.

<sup>363</sup> See *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, 50 (1982). The Supreme Court held that the subject matter jurisdiction of bankruptcy courts over certain civil claims, as established by Congress under the Bankruptcy Reform Act of 1978, violated the judicial power clause contained in Article III, section 1 of the United States Constitution. The problems caused by this decision (or by the original congressional grant of power) were obviously far more important and complex than the question of whether labor contracts could be rejected. In fact, the whole bankruptcy court system was up in the air and no one knew the true extent of bankruptcy courts’ jurisdiction. As Congress set about trying to address this jurisdictional problem, it apparently wished to also resolve the question of rejection of collective bargaining agreements. See THOMAS R. HAGGARD & MARK S. PULLIAM, *CONFLICTS BETWEEN LABOR LEGISLATION AND BANKRUPTCY LAW* 73–76 (1987). Because rejecting a collective bargaining agreement was never an intended purpose of the Bankruptcy Code, it seemed best to clear up any problems created by *Bildisco* without added negative publicity. See Frances McGinley, *Bankruptcy Code Section 1113: The Standard for Rejection of Collective Bargaining Agreements by Chapter 11 Debtors—Wheeling-Pittsburgh Steel Corp. v. United Steel Workers*, 791 F.2d 1074 (3d Cir. 1986), 60 TEMP. L.Q. 757, 757–59 (1987).

<sup>364</sup> See 11 U.S.C. § 1113(b)(2) (1994).

debtor has proposed modifications that are necessary to reorganization; (2) the proposal was made to the union representative; (3) the union representative rejected the modification without good cause; and (4) the balance of equities clearly favors rejection.<sup>365</sup> By the language of the statute, management's proposed modifications to the contract must be "necessary to permit the reorganization of the debtor."<sup>366</sup> While the statute requires that employers jump through a large number of procedural hoops prior to rejection,<sup>367</sup> most commentators agree that the most important requirement for rejection is the "necessity" requirement.<sup>368</sup> While some courts have held that this means "necessary" to the debtor's long-term survival,<sup>369</sup> others have held that the modifications or rejection must be "necessary" to avoid immediate liquidation of the debtor.<sup>370</sup> Obviously, far fewer contracts are rejected under the latter interpretation.<sup>371</sup>

According to at least one empirical study, rejection is attempted and granted

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<sup>365</sup> See *id.* § 1113(c).

<sup>366</sup> *Id.* § 1113(b)(1)(A).

<sup>367</sup> See *id.* § 1113(b), (c). Some modification can also be made on an interim basis, if necessary to "continuation of the debtor's business," in other words, to avoid liquidation. *Id.* § 1113(e).

<sup>368</sup> See Cameron, *supra* note 295, 845-46 at n.36 (listing a large number of articles discussing the "necessary" requirement). Professor Cameron argues that because so much emphasis has been placed on this particular requirement, that the other requirements have been largely ignored by scholars and even some judges. See *id.* at 846. One reason for this may be that if some courts interpret "necessary" to mean "necessary to avoid immediate liquidation," this test will be extremely hard to meet. As a result, the quickest way for a court to make a decision may be to look at this requirement first.

<sup>369</sup> See *Truck Driver's Local 807 v. Carey Transp.*, 816 F.2d 82, 89 (2d Cir. 1987); see also *In re Mile Hi Metal Sys.*, 899 F.2d 887, 893 (10th Cir. 1990) (holding that necessary does not mean "absolutely" necessary); *In re Ionosphere Clubs, Inc.*, 134 B.R. 515, 524-25 (S.D.N.Y. 1991) (finding "necessary to accommodate confirmation of Chapter 11 plan"). This interpretation seems to make the most sense under typical statutory construction. In section 1113(e), Congress states that a debtor is only entitled to make interim (rather than permanent) modifications to a collective bargaining agreement if it is "essential to the contribution of the debtor's business . . ." 11 U.S.C. § 1113(e). The language in section 1113(b) relating to permanent modifications or rejection, "necessary to permit reorganization" is far less specific.

<sup>370</sup> See *Wheeling-Pittsburgh Steel Corp. v. United Steel Workers*, 791 F.2d 1074, 1085 (3d Cir. 1986); see also *In re Sol-Sieff Produce Co.*, 82 B.R. 787, 795 (W.D. Pa. 1988) (holding that debtor met the statutory requirements, the nine steps under section 1113, and allowing the rejection of the collective bargaining agreement); *In re William P. Brogna & Co., Inc.*, 64 B.R. 390, 393 (E.D. Pa. 1986) (holding that the debtor did not satisfy the nine steps under section 1113 in order to reject the collective bargaining agreement).

<sup>371</sup> Compare *Carey*, 816 F.2d at 89, with *Wheeling-Pittsburgh*, 791 F.2d at 1085.



less frequently now that section 1113 is in place.<sup>372</sup> Thus, this statute appears to have achieved the goals for which it was enacted, namely to halt unilateral changes by employers in collective bargaining agreements protected under the NLRA and to reduce the likelihood that bankruptcy judges will approve rejection of these agreements without proper regard for national labor policies.<sup>373</sup>

Studying section 1113 may be helpful in drafting legislation protecting continuing-care residents from rejection, but there are some obvious differences between union workers and continuing-care residents. To start, unionized workers are protected by the NLRA,<sup>374</sup> a federal statute. As we have seen, there is plenty of state legislation purporting to protect CCF residents but no federal statute mandating such protections.<sup>375</sup> From the outset, then, there is less head-to-head competition between statutes protecting residents and the federal Bankruptcy Code, than there is between the NLRA and the Bankruptcy Code. Second, labor groups began lobbying Congress to legislate against *Bildisco* the day the decision was rendered.<sup>376</sup> There is no strong and organized lobbying effort on behalf of CCF residents.<sup>377</sup> Finally, there are probably fewer people affected by CCFs than by union contracts.<sup>378</sup>

On the other hand, numbers do not always govern which bankruptcy legislation is passed, nor *should* numbers dictate which legislation is passed.

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<sup>372</sup> See Cameron, *supra* note 295, at 895 (finding that since section 1113 was created, the rate of rejection of collective bargaining agreements has declined by about 9%, which the author believes is statistically significant and supportive of labor).

<sup>373</sup> See *id.* at 841–42 (citation omitted); Gregory, *supra* note 349, at 565–72.

<sup>374</sup> See 29 U.S.C. § 151 (1994).

<sup>375</sup> However, the National Continuing-Care Residents Association is currently working on federal legislation regarding CCFs, see Moss, *supra* note 74, at A1.

<sup>376</sup> See 130 CONG. REC. H7489, H7489 (June 29, 1984), reprinted in U.S.C.C.A.N., at 576 (bill introduced by Rep. Rodino). This bill became law five months later. See Bankruptcy Amendments of 1984, Pub. L. No. 98-353, 98 Stat. 390 (codified as amended in scattered sections of 11 U.S.C.). The bill was later incorporated into an omnibus bankruptcy bill that was passed on March 19, 1984, less than a month after *Bildisco*. See Bruce H. Charnov, *The Uses and Misuses of the Legislative History of Section 1113 of the Bankruptcy Code*, 40 SYRACUSE L. REV. 925, 947 (1989). For an extensive review of the legislative history, see *id.* at 946–69.

<sup>377</sup> While the Center for Aging has supported the passage of the various state statutes, it has not proposed any federal legislation.

<sup>378</sup> See Chinhui Juhn, *Wage Equality and Demand for Skill: Evidence from Five Decades*, 52 INDUS. & LAB. REL. REV. 424, 443 (1999). The percentage of workers covered by union contracts was 23.2% in 1980 and 16.1% in 1990. See *id.* This translated to approximately 5,271,600 people in 1980 and 4,016,000 people in 1990. See Population Estimates Program, Population Division, U.S. Census Bureau *Historical National Population Estimates: July 1, 1900 to July 1, 1998* (June 4, 1999) <<http://www.census.gov/population/estimates/nation/popclockest.txt>>. By contrast, about one million people are parties to CCF contracts. See Moss, *supra* note 74, at A1.

Some interests are simply more important than others. Moreover, the policies behind protecting workers are at least analogous to those protecting CCF residents.<sup>379</sup> Their life care contracts are unique to them and at least as important as terms of employment.

If section 1113 were to form the basis of model legislation for CCF legislation, the resulting CCF legislation could be far simpler than section 1113. Section 1113, after all, involves the rejection of contracts by which employees' rights are determined.<sup>380</sup> Thus, section 1113 requires that a whole host of process-oriented steps be taken by the debtor-employer, such as presenting current financial data to the union, making proposals to the union, negotiating in good faith, and so on.<sup>381</sup> If all these steps are taken *and* modification or rejection of the contract is necessary to the debtor reorganization, the labor contract can be rejected.<sup>382</sup> The workers must then find new jobs.<sup>383</sup>

Given the different circumstances surrounding CCF contracts, I question whether contract rejection should ever be permitted.<sup>384</sup> If it is to be permitted, however, I believe that the CCF contract should be harder to reject than a labor contract. Workers can presumably find new jobs. Residents cannot find new homes without great difficulty. Moreover, the whole purpose of CCFs is to provide homes and nursing care for residents, and if a facility cannot do that, it probably should not be in business. Employers, on the other hand, generally are not in business for the primary purpose of employing workers.

Looking at section 1113's requirements, it is clear that little is gained by requiring homes to jump through various procedural hoops in order to reject resident contracts.<sup>385</sup> Residents have few real options. They will have nothing to say about current financial information and no real way, at least as a group, to

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<sup>379</sup> Both types of contracts cover issues related to essential human needs. In the case of labor contracts, making money and providing for one's self and one's family, and in the case of CCFs, having a place to live and guaranteed nursing care, during the final stages of life.

<sup>380</sup> See 11 U.S.C. § 1113 (1994).

<sup>381</sup> See *id.*

<sup>382</sup> See *id.*

<sup>383</sup> Defeated workers can, of course, agree to continue working for the debtor after rejection at a lower rate. This happens from time to time, when the debtor stays in business. See *In re Appletree Mkts., Inc.*, 155 B.R. 431, 434 (S.D. Tex. 1993) (discussing, in the context of a question about mootness, how reversal of an order allowing rejection of a collective bargaining agreement would affect the rights of workers who continued to work for the debtor after rejection).

<sup>384</sup> I also question whether it is possible to simply forbid rejection. This has not been done yet for any interest group.

<sup>385</sup> See 11 U.S.C. § 1113.

accept modifications to their CCF contracts.<sup>386</sup> The only model that I could imagine borrowing from section 1113 is a trumped-up necessity requirement. New legislation could provide that CCF contracts could only be rejected to avoid immediate liquidation of a CCF. In other words, a CCF contract could never be rejected to improve profitability, but could be rejected if it were necessary to keep the facility in business, either under existing management or under the management of a new purchaser.<sup>387</sup>

Even under those conditions, I question whether there is any reason not to just forbid rejection. What is to be gained by letting such a facility stay in business? One possible reason to allow rejection would be that demand for these arrangements exceeds supply, and it is better to provide these services to new residents, even if some contracts are rejected along the way. This does not seem to be true, however. Demand does not exceed supply, and in fact, some CCFs that have filed for Chapter 11 have found it necessary to convert continuing-care residences to condominiums or rental units to fill unneeded space.<sup>388</sup> Second, demand for this type of service may decrease if rejection of resident contracts continues to be permitted.<sup>389</sup> This could affect the financial viability of the entire industry and hurt many existing residents. Finally, if a new Bankruptcy Code section limited rejection of these contracts but still permitted rejection when a facility changed hands, any CCF purchaser could buy a facility free of resident contracts. This would advance the interests of other creditors at the expense of CCF residents and definitely should be forbidden.

In the final analysis, then, even if rejection were permitted only to avoid liquidation, this approach would still be too lenient. I see little benefit to permitting rejection under any circumstances. An amendment to section 365, that made rejection financially infeasible, and at the same time precluded debtors from selling their assets free and clear of resident contracts, would be much preferred.

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<sup>386</sup> See *supra* notes 83–86 and accompanying text.

<sup>387</sup> This would mean making it very clear in the legislation that rejection needed to be necessary to avoid immediate liquidation. See *Truck Drivers Local 807 v. Carey Transp.*, 816 F.2d 82, 89 (2d Cir. 1987) (holding that necessary means necessary to rehabilitate in a nongeneral way); *Wheeling-Pittsburgh Steel Corp. v. United Steel Workers*, 791 F.2d 1074, 1085 (3d Cir. 1986) (holding that necessity means necessary to avoid liquidation).

<sup>388</sup> See, e.g., *In re Florida Brethren Homes, Inc.*, 88 B.R. 445, 446 (S.D. Fla. 1998) (noting that the economic decision was made to convert continuing-care units to condominiums).

<sup>389</sup> These arrangements have already suffered from some bad press, see Moss, *supra* note 74, at A1; Topolniki, *supra* note 59, at A1. These arrangements have also been subject to unusual levels of insolvency. See Ruchlin, *supra* note 59, at 56. Yet, they are still in demand. Allowing contract rejection would surely give the industry a further black eye and could cause financial and health problems for those who currently rely on such facilities.

### B. Another Bankruptcy Solution: Improved Priority

Another option is simply improving the status of resident claims. This could actually be done in conjunction with a 365-type amendment, and together these two options would be very protective of CCF residents.<sup>390</sup> There are two potential ways to improve a resident's likelihood of being able to continue residing at her CCF or having some of her entrance fee returned upon insolvency. Resident claims could be given priority under section 507 of the Bankruptcy Code,<sup>391</sup> or they could be made secured claims through appropriate state legislation.<sup>392</sup>

Priority claims are still unsecured claims and this improved status creates meaningful benefits to claim-holders *only* if the debtor has unencumbered assets from which to satisfy unsecured claims.<sup>393</sup> Some debtors will have unencumbered assets, but many will not. One way to provide protection to residents would be to provide that all resulting rejection damage claims will have priority status under section 507 even though the debtor can reject resident contracts to which it is a party as of the filing. This would eliminate many of the benefits of rejection for the debtor-facility.<sup>394</sup> Even then, however, the resulting priority claims would be unsecured claims, lower in priority than all secured claims.<sup>395</sup>

Giving residents a secured claim for their rejection damages would be even more beneficial than providing priority status for their rejection damage claims. State law defines what constitutes a secured claim, however, so the only way to do this uniformly would be to convince all states to enact statutes providing residents with valid and enforceable statutory liens.<sup>396</sup> While these liens will still be lower in priority than some other liens and security interests in a debtor's property, thus not guaranteeing payment or special treatment, they would still provide strong protection to residents, who would be paid before general unsecured creditors. If this protection were combined with protection against

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<sup>390</sup> See *supra* notes 332–47 and accompanying text.

<sup>391</sup> See 11 U.S.C. § 507 (1994) (providing a federal bankruptcy priority scheme).

<sup>392</sup> See *supra* notes 200–35 and accompanying text.

<sup>393</sup> Rejection damage claims are unsecured claims, see 11 U.S.C. §§ 365(g)(1), 502(g), that can only be paid a distribution if there are assets over and above those needed to satisfy secured creditors. See *supra* notes 233–35 and accompanying text.

<sup>394</sup> This is true because without the right to reject, all damages due under the contract must be paid in 100 cent dollars, rather than reduced “bankruptcy dollars.” See Westbrook, *supra* note 285, at 253–55, 335.

<sup>395</sup> Priority claims are unsecured claims, which means that they are not protected by collateral. See 11 U.S.C. § 507.

<sup>396</sup> See *supra* notes 200–36 and accompanying text.

rejection under 365(a), a typical case might progress as follows. A facility files for Chapter 11. Because section 365, as amended, provides that if resident contracts are rejected, either (1) the debtor has to pay whatever third party provides essential services to residents, or alternatively, (2) residents get a priority claim for all of their damages because both of these options will be very expensive for the debtor, any debtor that can reorganize, either through a plan or section 363(b) sale,<sup>397</sup> will leave the contracts in place. The debtor who must liquidate in a Chapter 7 obviously will need to reject the contracts,<sup>398</sup> but residents will receive some of the first available distribution dollars, after the payment of higher ranking liens and security interests.<sup>399</sup> This would seem to be the best residents can do, once a bankruptcy has been filed, and would be worlds better than the protections residents receive now. If they are to receive secured status, rather than unsecured priority status, however, all states need to enact

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<sup>397</sup> See 11 U.S.C. § 363(b) (1994) (allowing the debtor to sell its assets free and clear of most claims).

<sup>398</sup> A liquidating debtor must either reject its contracts or assume them and assign them to a third party, *see id.* § 365, because the debtor will cease to exist and thus be unable to perform the contract. Moreover, without amendment to the Bankruptcy Code, rejection will relegate the resulting rejection damage claim to an unsecured claim. *See id.* §§ 365(g)(1), 502(g); *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 530 (1984); *Steward Foods, Inc. v. Broecker (In re Steward Foods)*, 65 F.3d 141, 144 (4th Cir. 1995).

<sup>399</sup> This assumes that states enact statutes giving the residents valid statutory liens. If they do not, and if the Code ultimately gives resident claims priority status, then the resident claims would be satisfied after all perfected secured claims and all administrative priority claims. *See* 11 U.S.C. § 503 (explaining that a secured creditor's collateral can only be surcharged with the administrative expenses of the estate if incurring the expense preserved the secured creditor's collateral). Then, depending on the rank of the priority assigned to resident claims, the claim would be paid ahead of most, but probably not all, other claims. Administrative claims are always paid ahead of all priority claims, as costs of preserving the estate. *See id.* § 503(b)(1)(A). Incidentally, these costs include the fees and expenses of the debtor's attorneys. *See id.* § 503(b)(1)(C)(4).

While I would like to see residents receive an administrative priority claim if their claims are rejected, such status is generally reserved for postpetition debts that are incurred in order to keep the debtor alive. I see no real way to fit resident claims into this paradigm. Thus, as a practical matter, resident claims will always be paid after at least some other priority claims in any event. Creating a priority for resident claims is a sound idea, and unlike some similar priorities that have been proposed in recent years, I do not believe that creating a priority for resident claims will unduly burden debtor-companies or the bankruptcy system. *See* Jill L. Uylaki, Note, *Promises Made, Promises Broken: Securing Defined Benefit Pension Plan Income in the Wake of Employer Bankruptcy: Should We Rethink Priority Status for the Pension Benefit Guaranty Corporation?*, 6 ELDER L.J. 77, 77 (1998) (proposing that Pension Benefit Guaranty Corporation (PBGC) claims receive a priority under the Bankruptcy Code, which I feel could have an enormous impact on companies' ability to reorganize).

effective statutory lien statutes.<sup>400</sup> I know of no way to make this happen, other than by educating states about the benefits of such statutes.

### C. Making CCFs Ineligible for Bankruptcy

As a final possibility, section 109 of the Bankruptcy Code, which currently provides that banks and domestic insurance companies are ineligible for bankruptcy, could be amended to make CCFs ineligible for bankruptcy as well.<sup>401</sup> While this would certainly leave states free to legislate CCFs, it is impossible to amend section 109 in this way at this time because many states have not yet passed any CCF legislation.<sup>402</sup> This would leave some CCFs with no state regulatory or insolvency scheme.<sup>403</sup> It would also be inconsistent with the bankruptcy eligibility of the rest of the health care system, which currently is eligible for bankruptcy protection.<sup>404</sup> If Congress ultimately decides that CCFs are enough like insurance companies to warrant such an exclusion, and if states fully regulate this industry, CCFs ultimately could be excluded from bankruptcy protection.<sup>405</sup> The question that must be answered first, however, is whether this would be beneficial to residents. Given bankruptcy courts' extensive experience with reorganization and insolvency, I am not convinced that excluding CCFs from bankruptcy protection would benefit residents.

## V. CONCLUSION

Health care and bankruptcy are intersecting more and more due to financial problems in this industry.<sup>406</sup> Among the many people affected by the higher

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<sup>400</sup> See *supra* notes 200–236 and accompanying text.

<sup>401</sup> See 11 U.S.C. § 109. The legislative history of section 109 indicates that banking institutions and insurance companies are excluded from liquidation under the bankruptcy laws because various regulatory laws provide for their liquidation. See H.R. REP. NO. 95-595, at 318 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6275.

<sup>402</sup> See *supra* notes 169–283 and accompanying text.

<sup>403</sup> See *In re Florida Brethren Homes, Inc.*, 88 B.R. 445, 447 (S.D. Fla. 1998) (stating that even Florida's CCF statute, which contains rehabilitation provisions, does not contain an adequate state regulatory statement for CCFs).

<sup>404</sup> See 11 U.S.C. § 109 (1994); see generally *Sullivan v. University Med. Ctr.*, (*In re University Med. Ctr.*) 973 F.2d 1065 (3d Cir. 1992). This case raises the question of whether CCFs are more like health care providers or more like providers of annuities.

<sup>405</sup> States probably also need to form guaranty funds. No industry has ever been precluded from bankruptcy protection unless the state has created a guaranty fund from which to pay claims. See 11 U.S.C. § 109; H.R. REP. NO. 595, at 318–19 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6275–77.

<sup>406</sup> See Michael Kraten & R. Michael Yesh, *Health Care Organizations—The Business*

rates of health care facility insolvency are parties to continuing-care contracts, who have prepaid for nursing care with some or all of their life savings.<sup>407</sup> States have seen these risks and enacted statutes that protect residents from harm.<sup>408</sup> These statutes aptly address a number of important issues, but do not adequately protect residents in the event of a facility's insolvency.<sup>409</sup>

Enacting a state statute, to protect citizens against insolvency in a particular industry, is of limited utility. Because the Bankruptcy Code preempts much of this legislation, much of it is unenforceable at the time when citizens need it most. That does not mean that all of this legislation is worthless, however.

Statutes subject to preemption fall into three categories. First, some legislation—such as financial reserves, reporting requirements, and actuarial studies—may not be enforceable during a bankruptcy case due to the debtor's financial limitations, but are fully enforceable outside bankruptcy, and may even prevent bankruptcy.<sup>410</sup> These types of legislation are very valuable, despite preemption possibilities. Second, some statutes like those imposing statutory liens that are voidable in bankruptcy, are never effective, are a waste of resources, and actually harm citizens by misleading them about their rights and creating an incentive for a facility to file for bankruptcy.<sup>411</sup> Needless to say, these statutes should be repealed and replaced with more effective ones. The third category of statutes, those relating to the rehabilitation of a CCF, create more complicated issues. Many of these provisions, which attempt to exert control over both state insolvencies and federal bankruptcies, are probably unenforceable at this time.<sup>412</sup> These statutes may serve another purpose, however. States may be aware that they are ineffective, but may hope that the provisions will deter CCFs from becoming insolvent or misusing reserves. States also may hope that someday, given the public health and welfare issues involved, they will be given control over these cases. In other words, the statutes may

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*Implications of Capitation Revenue Methodologies*, 14 AM. BANKR. INST. J. 15 (1995). As healthcare is evolving, organizations must evolve by offering their members new programs. Providers have evolved by joining managed care plans. *See id.* This has led to changing reimbursement policies. The managed care arena has caused providers to agree to reimbursement methods that may not cover their costs. Organizations have opted for methods that may lead to potential profits and increased risk. *See id.*

<sup>407</sup> *See supra* notes 10–11 and accompanying text.

<sup>408</sup> *See supra* notes 167–283 and accompanying text.

<sup>409</sup> This creates a strong risk that people will be misled because some statutes purport to protect residents from insolvency but are not enforceable in bankruptcy. *See supra* notes 201–36 and accompanying text.

<sup>410</sup> *See supra* notes 171–99 and accompanying text.

<sup>411</sup> *See supra* notes 201–36 and accompanying text.

<sup>412</sup> *See supra* notes 237–56 and accompanying text.

express states' wish lists, rather than their understanding of the actual law. This may be an acceptable way to legislate, assuming no one is misled into thinking that the provisions are effective. On the other hand, statutes are not reflections of legislative intent. They represent actual attempts to make law, and it is far preferable that the laws enacted be enforceable.

The problems caused by CCF statutes raise interesting questions about the state legislative process. Some of the statutes indicate that state legislatures are unaware of the existence of federal statutes on the same subject matter that they are legislating.<sup>413</sup> Given the sheer volume of both state and federal statutes, this is not surprising. While the state legislative process may at times be uninformed and arbitrary, the same can be said of the bankruptcy legislative process.<sup>414</sup> Problems are often considered in a vacuum and through narrow exceptions, rather than by looking at the big picture.<sup>415</sup> Amending the Bankruptcy Code to protect residents would admittedly be another form of narrow, piecemeal legislation, and the same would be true of creating a new priority status for residents. Bankruptcy Code amendments may be necessary despite these downfalls, however.

CCFs provide a valuable service to society. If these facilities are going to be useful, they must be financially viable, and residents must be protected from the loss of their investment in the event of insolvency. State statutes can, and often do, effectively regulate financial viability.<sup>416</sup> Given the existing provisions of the Bankruptcy Code and the uncertainty about whether states can preclude CCFs from filing for bankruptcy, the only certain way to protect residents against CCF insolvency is to amend the Bankruptcy Code. This cannot be accomplished through state legislation, much of which is not enforceable in bankruptcy, and creates a dangerous and false sense of security that this important issue has been adequately addressed.

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<sup>413</sup> For example, federal statutes provide that statutory liens are effective only in bankruptcy, *see supra* notes 201–36 and accompanying text, and allow a state official to appoint a trustee in a bankruptcy case, *see supra* notes 237–56 and accompanying text.

<sup>414</sup> *See supra* notes 316–21 and accompanying text.

<sup>415</sup> The section 365 exception to rejection for timeshare holders, for example, is not particularly useful legislation and was enacted without any indication that the legislation was needed. *See supra* notes 316–20 and accompanying text. No doubt, amending section 365 to make it more difficult to reject life care contracts is far more necessary.

<sup>416</sup> One way to improve this state legislation is to strengthen the certification and reserve fund requirement to keep facilities from filing for bankruptcy in the first place. *See supra* notes 183–99 and accompanying text.